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85%

THE WHITE HOUSE
WASHINGTON

1976

1% = 1 Investment tax credit TN
bus discount temporary
1% = 1¼ Permanent Corp tax rate 2% + 2%
Integration = Capital gains elim.
Deferral foreign income

> Much relief - little reform how to avoid?

PN > $50-100T cut $1352 - (most) pol problem - Table 6

> Define "ratably" minerals depletion reduction

> Tax transfers at death - explain carryover basis rule "push back 10 yrs"?

> Balanced budget (p12-15 memo)

> Corporate surtax exemption - explain (1st $25T)

> Real estate depreciation - 150% Decl Bal M fam Straight line for multifamil

> % depletion hard minerals, oil & gas

> Intangible drilling costs - exploration only min tax ?

> Exemptions remaining for minimum tax

> Xfer payments - income > $20/30T

> RR contribution to pensions

> Veterans living expense under G I Bill

> Legal insurance for employees

> Entertainment

> Meals

SCPY > Interest buildup on life insurance - tax

> Taxable bond option - 35% or 40%?

> Accumulated DISC profits

> Deferral of foreign earnings

PKN > Partial integration - 20%

> ITC +3% → 2% → 1%

> Depreciation while still building

Pi Lower rate structure for non itemizers

PJ > Venture capital stock - 10 yr capital gain - $1M

KPSCN > Indexing investment for capital gains

PF > Interest deduction - $10T limit on all
> Effect on low/mod housing vs other investment incentiv

Comparisons of Net Tax Reductions and Effective Tax Rates Under Alternative Rate Schedules

(1976 Level of Income)

Expanded income class	Expanded income and imputed corporate income	Net Tax Reductions 1/ Present law tax 1/	50% Rate starts at $80,000 on joint return	50% Rate starts at $70,000 on joint return	50% Rate starts at $60,000 on joint return	Effective Tax Rates 1/ Present law	50% Rate starts at $80,000 on joint return	50% Rate starts at $70,000 on joint return	50% Rate starts at $60,000 on joint return
($000)	(........................$ millions				........................)	(................	percent		....................)
Less than 5	65,426	3,053	-635	-657	-669	4.6	3.7	3.7	3.6
5 - 10	159,261	11,805	-2,374	-2,344	-2,427	7.4	5.9	5.9	5.9
10 - 15	212,583	22,343	-3,803	-3,884	-4,008	10.5	8.7	8.7	8.6
15 - 20	215,754	26,956	-3,689	-3,933	-4,042	12.5	10.8	10.7	10.6
20 - 30	255,093	39,457	-4,245	-4,431	-4,524	15.5	13.8	13.7	13.7
30 - 50	144,104	29,146	-2,260	-2,317	-2,285	20.2	18.7	18.6	18.6
50 - 100	86,522	23,536	-1,470	-1,253	-742	27.2	25.5	25.8	26.4
100 - 200	41,978	13,489	-24	+105	+283	32.1	32.0	32.4	32.8
200 & over	39,231	13,010	+820	+851	+896	33.2	35.3	35.3	35.4
Total	1,219,950	182,793	-17,670	-17,853	-17,508	15.0	13.5	13.5	13.5

(Office of the Secretary of the Treasury
Office of Tax Analysis)

September 19, 1977

1/ Individual and imputed corporate.

Comparison of Alternative Tax Rate Schedules 1/
Joint Return with Two Dependents

Expanded Income Class ($000)	Average Tax 1977 Law	50% Rate Starts at $80,000 on Joint Return		50% Rate Starts at $70,000 on Joint Return		50% Rate Starts at $60,000 on Joint Return	
		Average Tax	Average Tax Change	Average Tax	Average Tax Change	Average Tax	Average Tax Change
Less than 10	9	-77	-86	-76	-85	-77	-86
10 - 15	867	488	-379	492	-375	483	-384
15 - 20	1,739	1,376	-363	1,357 19	-382	1,347 10	-392
20 - 30	3,117	2,702	-415	2,682 20	-435	2,672 10	-445
30 - 50	6,287	5,601	-686	5,582 19	-705	5,582 0	-705
50 - 100	16,336	14,775	-1,561	14,485	-1,351	15,459	-877
100 - 200	40,885	40,126	-759	40,865	-20	41,785	+900
200 and over	127,666	151,311	+23,645	152,071	+24,405	152,977	+25,311

(Office of the Secretary of the Treasury
Office of Tax Analysis)

September 19, 1977

1/ Excludes imputed corporate tax and corporate tax changes.

1978-1979 Economic Forecast
Major Results

	1977 I	1977 II	1978 I	1978 II	1978 Year[1]		1979 Year[1]
BASE							
GNP growth	6.8	4.7	4.6	3.5	4.1		3.3
Unemployment (end of period)	7.0	6.8	6.3	6.4	6.4		6.4
Rate of inflation	6.2	6.1	5.7	6.7	6.2		6.1
With Tax Reform 1/1/79							
GNP growth	6.8 5.7	4.7	4.6 4.2	3.8	4.3	4.5	4.6
Unemployment (rest of period) . . .	7.0 6.9	6.8	6.3 6.3	6.3	6.3	6.1	5.9
Rate of inflation	6.2	6.1	5.7	6.8	6.3	6.3	6.3
With Tax Reform 7/1/78							
GNP growth	6.8	4.7	4.6 4.7	4.8	4.9	4.5	4.1
Unemployment (rest of period) . . .	7.0	6.8	6.3	6.2	6.2		5.8
Rate of inflation	6.2 6.2	6.1	5.7	6.9	6.3	6.4	6.4
With Tax Reform 7/1/78 and extra $7 Billion in FY '79 Expenditures							
GNP growth	6.8	4.7	4.6 5.2	5.7	5.1	5.0	4.8
Unemployment (rest of period) . . .	7.0	6.8	6.3	6.1	6.1		5.5
Rate of inflation	6.2	6.1	5.7	6.9	6.3	6.4	6.5

1/ 4Q of previous year to 4Q of indicated year.

OVERVIEW

Overview of Tax Reform Option Papers

This paper is an overview of nine specific option papers which include Treasury recommendations on the tax reform program and other agency comments on portions of the program with which they are particularly concerned.

This overview paper first summarizes the major elements of the tax reform proposals in light of our objectives: simplification, equity, and aid to growth and investment.

Second, it outlines the revenue impact of the proposals and their size relative to prior reductions, the relationship between the individual and business cuts, and the distribution of the reductions by income class.

Third, it outlines the relationship of these tax proposals to budget strategies developed by CEA and OMB.

Fourth, it shows the relationship of the tax package to the state of the economy and projections to 1981.

Fifth, it discusses the possibility of delays in the revenue gains by Congress and the timing of committee action.

Sixth, it reviews Treasury consultations with other agencies. Their views are dealt with specifically in each of the option papers to which they relate. The full comments received by the Treasury from other agencies are attached as a portion of the appendix to the option papers.

I. Major Elements of Tax Proposals

The major elements of the Treasury tax proposals can be seen by examining their impact on the three objectives:

- Simplify the tax laws for individuals and business.
- Improve the equity of the tax system.
- Aid growth and investment.

Tax Simplification

Tax simplification for the average taxpayer is provided primarily:

- by combining the personal exemption with the present tax credit into a new $250 tax credit, and
- by eliminating or reducing itemized deductions which involve the most recordkeeping or computations, but are not major deductions.

These changes will increase to 83 percent the number of taxpayers using the standard deduction. Those using the standard deduction will have a simple return which they should be able to fill out themselves. Those who continue to itemize will also find their return easier to fill out. Both those who use the standard deduction and most of those who itemize will determine their tax from tax tables, which will avoid the necessity of multiplication on their part. Those using the tax tables should be 96 percent of all return filers.

For the tax law overall, probably the most significant simplification is the taxation of capital gains as ordinary income. This will make it possible to delete a large number of special provisions in the tax law and also remove a major cause of litigation in the courts.

Tax Equity

Tax Expenditures.--The best measure of the improvement of tax equity is shown by the effect of the recommendations on tax expenditures. (Tax expenditures are departures from taxing everyone on all income under a progressive rate structure.)

Tax expenditures for individuals are estimated at $85 billion and for corporations at $27 billion. In the case of individuals the tax reform proposals decrease these tax expenditures by $13 billion and for corporations by $4 billion. This means that for individuals tax equity is improved by eliminating 16 percent of the tax expenditures, and for corporations by eliminating 15 percent of these expenditures. Charts 1 and 2 show the important tax expenditures for individuals and corporations. The shaded areas in each of these charts identify the tax expenditures which the Treasury proposals reduce to some extent.

Ind - 16%
Bus - 15%

The tax expenditure categories where equity is most improved by the proposals are:

capital gains,
deductibility of taxes paid,
capital gains at death,
deductibility of medical expenses,
depreciation on buildings, and
exclusion of interest on State and local debt.

In the corporate area tax equity is improved by reducing tax expenditures for:

DISC,
excess of percentage over cost depletion,
capital gains, and
exclusion of interest on State and local debt.

There are relatively few tax expenditure categories for individuals which are not affected by the Treasury proposals:

investment tax credit,
additional exemption for those over age 65,
deductibility of contributions,
exclusion of interest on life insurance savings,*/ and
exclusion of social security beneifts.

The reasons for not affecting these tax expenditures of individuals are:

- The last two of these categories are dicusssed at length in the option papers (option papers V and VII) and are omitted primarily because it is believed that their inclusion would be generally unacceptable.

- No reduction is proposed for the investment credit for individuals because it is a desirable investment stimulant for individuals as well as for corporations.

- The additional exemption for those over age 65 is not affected because our general social standards favor preferential tax treatment for the elderly.

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*/ The CEA and DPS favor taxing the interest element on life insurance savings.

° Charitable contributions are not directly reduced because of general social standards which are favorable to these preferences. However, these deductions may be somewhat adversely affected by lower tax rates--especially the top rate reductions--which may dull the incentives for charitable giving.

The proportion of total corporate tax expenditures not affected by the proposals are much larger although fewer in number:

asset depreciaton range,
investment tax credit,
corporate surtax exemption,
expensing research and development expenses, and
deferral of foreign source income.*/

The reasons for not affecting these corporate tax expenditures are:

° Asset depreciation range is a form of accelerated depreciation and important to capital formation.

° The investment credit is a needed stimulant for investment.

° A reduction in the corporate surtax exemption would be politically difficult to do because it benefits small business. Helping small business tends to help competition.

° Expensing research and development tends to encourage new processes and devices which improve productivity.

° Deferral of foreign source income is a topic discussed extensively in option paper VIII, with different views expressed.

Tables 1 and 2 at the end of this paper indicate the impact of the tax reform proposals on tax expenditures by category. (The reduction in tax rates will have a further but indirect impact by reducing the relative value of the remaining tax expenditures.)

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*/ The CEA and DPS favor eliminating deferral of foreign source income.

Progressivity.--Another measure of the tax equity of the proposals is their impact on progressivity of individual income taxes (a system is classified as progressive if the effective rate of taxes rise as the income level rises).

The increase in progressivity in effective rates under the proposals results from a combination of a reduction in rates and the tax reform measures. Effective rates under the Treasury proposals are decreased for all income classes up to $100,000 of expanded income.*/ The increase in effective rates in the income class of $100,000 to $200,000 is relatively slight, increasing from 29.5 percent to 30.8 percent. For the $200,000 and above class (the average income in this category is $385,000) the effective rate increase is from 30.0 percent to 35.3 percent. These effective rates for individuals are shown in chart 3.

If the corporate tax and corporate income is imputed to shareholders, there is little change in the effective rate under the proposals. For example, in the income bracket above $200,000 the effective rate under present law is 33.2 percent and under the Treasury proposals is 35.3 percent, the latter being almost the same as the effective rate for individuals ignoring the corporate tax. Chart 4 shows the increase in the progressivity of the effective rates under the Treasury proposals, taking into account the corporate rate changes.

While the effective rates under present law are progressive (and those under the proposals significantly more so), a major failing in tax equity in the past has been the considerable variation in effective rates within each income class. Under present law the dispersion of effective rates is greatest at the highest income level; namely, that applicable over $200,000. The Treasury proposals reduce the dispersion of effective rates in all income classes but are especially effective in decreasing the dispersion in the higher income classes. This is illustrated in chart 5.

Marital Status.--Tax equity has been significantly improved under the Treasury proposals by the addition of a special deduction for two-earner families. The effect of this deduction and other proposed changes will be to reduce to $122 or less the so-called marriage penalty where the income is split 70 percent-30 percent for marital partners for up to a total family income of $30,000.

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*/ Expanded income is generally equal to adjusted gross income plus preference income subject to the minimum tax minus investment interest to the extent of investment income.

Tax equity for single persons is also improved by the rate schedule which assures them that they will never pay more than 15 percent more taxes than a married couple with the same income--under present law this rises to 20 percent over that for married couples.

Aid to Growth and Investment

The proposals offered will stimulate capital investment and productive effort for individuals. The principal features designed to benefit production by individuals is the $24 billion reduction in tax rates (at 1976 income levels). The top rates are reduced from a maximum of 70 percent to a maximum of 50 percent.

The proposals for business tax reductions should also help capital investment. They involve net reductions of from $7 billion to $9 billion in the years 1979 through 1982 but in the long run net reductions of less than $3 billion at 1976 levels of income. The principal forms of relief provided for business are:

° Relief from double taxation at a 20 percent withholding tax rate (by a 25 percent gross up in the dividend).

° Investment tax credit for industrial buildings structures.

° Raising the investment tax credit limitation from 50 percent to 90 percent.

° For a temporary period, providing 3 additional points in the investment credit which are then phased out. ?

° 2 percentage point reduction in the general corporate rates.

While it is clear that proposals offered will stimulate capital investment and productive efforts of individuals, because of the taxation of capital gains as ordinary income charges will be made to the contrary. The capital gains for individuals and corporations, taken together, involve a revenue pickup of approximately $6.1 billion (on a full-year basis), but there is much larger relief provided for individuals in the upper brackets and for businesses and their shareholders. This, however, will be an issue raised in the debate on the tax reform package.

II. Size of the Package

In terms of full-year effect, the proposals result in a net tax reduction of $18.0 billion (at 1976 income levels). This consists of:

Tax reforms, $15.8 billion
Tax reductions, $33.7 billion.

These estimates do not take into account the economic stimulative effect of the proposals (this effect is discussed below).

The overall revenue effect of these proposals by year (again, without induced revenue effect from an improved economy) is:

Fiscal Year 1979, $16.6 billion
Fiscal Year 1980, $29.6 billion
Fiscal Year 1981, $38.0 billion
Fiscal Year 1982, $41.2 billion.

Tables 3, 4, and 5 at the end of this paper show these revenue effects in each of the fiscal years 1979 through 1982 and also indicate the break between individual and business tax reforms and tax reductions.

The improvement in the economy, induced by the tax reductions provided by these proposals, has the effect of raising revenues generally above the level which would exist in the absence of these proposals. On this basis, the revenue loss of these proposals is reduced by $1 billion in Fiscal Year 1978, by $9 billion in 1979, by $17 billion in 1980, and by $20 billion in 1981. This means that the net revenue change induced by the proposals outlined in these option papers is as follows:

Fiscal Year 1979, $15.7 billion
Fiscal Year 1980, $20.9 billion 7
Fiscal Year 1981, $20.8 billion
Fiscal Year 1982, $21.2 billion.

Comparison with Reduction in 1964 Act

It is difficult to understand the implications of the size of any current tax reduction. Reductions today, in order to have the same impact as reductions in prior years, need to be larger because the size of the economy has grown. The 1964 tax reduction, which was viewed as an important factor in the growth in the economy in the early part of the 1960s, was a reduction of $15.2 billion. Given the GNP at that time of $688.1 billion, this was a reduction of 2.2 percent of that GNP. Given the GNP expected in 1981 of $2,836 billion, a comparable tax cut effective in 1981 would amount to $62.4 billion. This can be contrasted to the reduction called for in the Treasury proposals of $38 billion in 1981. The reduction in 1964 and under the current proposals can be compared as follows:

1964 = 2.2%

Reduction in--

1964 Act, 2.2 percent of GNP
Treasury proposals in 1981, 1.4 percent of GNP

Relationship of Individual and Business Cuts

The individual tax proposals presented here will decrease revenues by $15.3 billion. (This is composed of a pickup of $11.8 billion in tax reform, together with tax reductions of $27.1 billion.)

For business, the proposals show a net tax reduction of $2.6 billion (this reflects capital formation proposals of $6.6 billion offset by tax reform proposals of $4.0 billion). This implies that the business reduction is about 14 percent of the total. However, this understates the business tax reductions for the period ahead since it omits the temporary increases in the investment credit. A 3 percent increase in the investment credit is provided for 1978 and 1979, a 2 percent increase for 1980, and 1 percent increase for 1981. ?

What this means is that in the fiscal year 1979 net individual reductions are $10 billion and net corporate cuts are $7 billion. By 1980 the individual reductions will have grown to $21 billion while the business reductions are slightly under $9 billion. In the fiscal year 1981 the net individual reductions are about $29 billion as contrasted to $9 billion for business. In that year the individual reduction is about three-fourths of the total.

	Bus	Inc
FY 1979	7	10
80	9	21
81	9	29

As is indicated elsewhere in this paper, stimulus to encourage investment is needed in the period immediately ahead. For that reason the business reduction as a percent of the total reduction is substantially larger in 1979 and 1980, but for individuals the reductions continue to grow in each of the 4 years.

Individual Taxes as a Percent of Personal Income

In considering the size of any individual income tax reduction, it is important to keep in mind the historic relationship of individual income taxes to personal income. For the years 1960 through 1977, individual taxes as a percent of personal income have remained in the range from 9.2 percent (in 1965) to a high of 11.6 percent (in 1969)-- actually, taxes had remained in this range back to 1951. This percentage relationship tends to increase year by year until a tax reduction is provided, then the percentage falls to something like the starting point and the increase begins again. Major tax reductions were provided in 1964, 1969, 1971, and 1975. Chart 6 shows these percentage relationships.

9.2 - 11.6 %

The chart also indicates that if no tax reductions were provided in the period immediately ahead individual income taxes as a percent of personal income would rise from 10.2 percent in 1976 to 13.6 percent in 1982--2 percentage points above the previous high since 1945. Even with the major tax reductions being proposed, individual taxes as a percent of personal income still will rise to 12.0 percent in 1982--0.4 percent above the previous high.

no tax cut 13.6% - 1982
c tax cut 12% - 1982

Major tax reductions are an essential part of tax reform; the country is accustomed to rates within this range of 10 to 11 percent, and even if it were not proposed by us it seems probable that the public would demand, and the Congress would provide, the reductions necessary to keep taxes within this 10 to 11 percent range.

Income Distribution

One measure of the distribution of the tax reductions was shown above, the change in progressivity under the Treasury proposals in the various income classes. Another measure of the income distribution is the distribution of the tax burden before and after the proposed changes. The Treasury proposals for a joint return with two dependents, for example, show tax reductions in all income classes up to $200,000. The biggest dollar reduction is in the class from

$50,000 to $100,000--$1,352--but in percentage terms this is the smallest reduction of any income class up to that level. The largest percentage reductions are in the lowest income classes with those below $10,000 resulting in a negative tax. The percentage changes for other income classes are:

Pol prob

Income Class	Percentage Change
$10,000 - $15,000	-43
15,000 - 20,000	-22
20,000 - 30,000	-14
30,000 - 50,000	-11
50,000 - 100,000	- 8
100,000 - 200,000	0
Over 200,000	+19

A tax increase is shown only in the case of a family with income over $200,000 (an average income of $385,000). Here the tax increase is slightly over $24,000, for a 19 percent increase. Table 6 at the end of this paper shows the average tax burdens for a four-person family under present law and under the Treasury proposal at different expanded income levels. (A series of tax burden tables is presented in the appendix for all of the Option Papers.)

Phase-In of Proposals

The tax reduction, and also to some extent the tax reform, proposals are phased in over the years through 1981. Some of the tax reforms are phased in because of the difficulty in adjusting to the changes immediately. In those cases where a tax subsidy has been available to an industry over a long period of time, it is difficult not to take this away gradually. In other cases it is necessary to apply the tax reforms to new actions which occur in the future.

The tax reductions in part are larger by 1981 because income levels are higher. In addition, the reductions are phased in both to match the tax reform increases and to reflect our estimate of the economic requirements of the economy (these latter features are analyzed in the next section).

Some of the principal provisions phased in are:

° The personal credit for individuals is $230 per person in 1979, $240 in 1980, and $250 in 1981.

° Rate reductions up to income levels of $16,000 are fully effective in 1979; for rates above that level the reductions are made approximately one-third in each of the years 1979, 1980, and 1981. The top rate is reduced from 70 percent to 60 percent in 1979, to 55 percent in 1980 and to 50 percent in 1981. <

° The capital gains exclusion for individuals is reduced from 50 percent to 30 percent in 1979, to 15 percent in 1980, and to zero thereafter. The capital gains rate for corporations is increased from 30 percent to 36 percent in 1979, 42 percent in 1980 and the full 46 percent in 1981.

° The corporate rate is decreased from 48 percent to 47 percent in 1980 and to 46 percent in 1981.

° The phase down in bad debt deductions for mutual savings banks and savings and loans would apply in the 5-year period beginning in 1979.

° The reduction in percentage depletion for hard minerals occurs ratably over the 10-year period beginning in 1979. ?

° The tax on transfers at date of death would apply beginning in 1979 but only to the extent of appreciation which occurred in 1977 and later years.

° The option with respect to taxable State and local government bonds would apply only in the case of bonds issued in 1979 and latter years.

III. Relation of the Tax Reform to Economic Strategies

The Budget Margin

In the discussion that follows it is assumed for planning purposes that Strategy II is followed. This was outlined in the July 5 memo of the Council of Economic Advisers. It is a balanced, high-employment budget for 1981. "High employment" was defined as a 4.75 percent unemployment rate. In this strategy, then, tax rates and expenditures programs were set so that revenues would match expenditures at high employment.

CEA and OMB reviewed the earlier estimates of the budget margin, taking into account:

(i) the more pessimistic outlook on inflation,

(ii) the likelihood of somewhat higher interest rates, and

(iii) the effects of the new farm bill on the budget.

It is now estimated that assuming (i) current tax laws, (ii) existing and proposed Federal programs, and (iii) high employment, that revenues would exceed expenditures by $43 billion. Under Strategy II, this "budget margin" could be used for some combination of tax reduction or expenditure increases, while still balancing the high-employment budget.

After taking these factors into account, the margin for fiscal year 1981 now looks as follows:

Current margin estimate	$43 billion
less: proposed tax reform	-38
equals: available margin after tax reform	$ 5

no stimulus factor for tax cut?

21

#26

$-11 ?

Against this margin must be set a list of possible expenditure increases, some in response to highly probable Administration proposals, some stemming from Congress. At this stage the estimates are necessarily only educated guesses. Some examples: urban assistance and youth employment programs; increasing real defense spending at 3 percent per year; allowing at least partially for inflation-induced increases in nonindexed Federal programs; and finally, the unknown crises and contingencies which will inevitably arise over the next 3 years.

In round numbers the total of easily identifiable claims on the budget margin totals about $20 billion, compared to a remaining margin of $5 billion. Savings from zero-based budgeting and other economies could be applied to close the gap, but we have no way of estimating their magnitude.

Finally, the above calculations assume that the Administration's energy bill is enacted intact with no budget impact in 1981. In fact, the House bill raises $7 billion more in net revenues in 1981 than our proposal. To the extent that some of the net revenues from the wellhead tax were used to finance the proposed $250 credit--rather than added to it--the net cost of tax reform in 1981 would be lower than $38 billion and the remaining budget margin larger. In any case, the outcome of the energy bill is so uncertain that it will be necessary to decide how to proceed after passage (for further discussion, see Option Paper No. I).

IV. Relation of the Tax Package to the Economy, 1977-1981

The Need for Stimulus

More important than the high-employment budget just discussed is the actual performance of the economy over the next 4 years. In addition to the upcoming budget, the tax package proposed will be the major fiscal policy action in 1979 through 1981, and therefore there has been a careful consideration of the kind of fiscal program needed over the next 3 years.

The stimulus package passed this summer adds a fiscal stimulus of $3 billion in fiscal year 1977, $18 billion in fiscal year 1978, and then drops off in succeeding years. The momentum of private sector demands will not carry the economy to high employment. In the absence of unanticipated strength in exports or domestic spending, and with no tax cuts, the unemployment rate should slowly decline to the vicinity of 6.25 percent at the end of 1978 and then stagnate near 6 percent during 1979, 1980, and 1981.

Given the outlook, a tax reduction of $15 to $20 billion in 1979 will be needed to maintain the momentum of economic expansion through 1979.

Projections of Economic Performance With and Without the Tax Cuts

Although forecasting as far forward as 1981 cannot be done with any precision, it is necessary to determine roughly the appropriate size of the tax reduction accompanying tax reform.

Table 7 shows the results of our forecasts. It is assumed that tax reform and reductions are phased in on the schedule outlined earlier. In addition, it is assumed that Federal expenditures use up the remaining $5 billion margin but do not go beyond it. The results:

- Without the tax proposals, the economy stagnates after 1978; with the tax proposals, the economy continues the 5 percent annual growth rate through 1979 and even into 1980. Thus, the tax reform bill will be a major step toward meeting the commitment to bring the economy back to full employment.

- The tax bill will provide economic expansion led by the private sector rather than through government expenditures.

° The real income of an average family of four after tax will increase by about $500 in 1979 and by almost $800 in 1980 due to economic growth and the tax bill.

° The program will provide a substantial stimulus to investment. Because of the careful choice of tax increases and investment incentives and the indirect stimulus of a stronger economy, it is expected that business investment in 1980 and 1981 will be some $20 billion higher than would otherwise be the case.

° The more vigorous economy and tighter labor markets brought about by the tax cuts could add about 0.7 percent per year to the inflation rate by 1981.

The best estimate is that the tax cuts would bring the economy close to the target of 4.75 percent by 1981. But since GNP would be a little bit below this target, the actual budget deficit in 1981 would be in the range of $10 to $15 billion.

!!

Relation of the Tax Proposal to 1978

One problem which the tax package does not address is the possible need for additional economic stimulus in 1978. The forecast for 1978, assuming no shortfall of Federal expenditures below the Mid-session Review estimate, is for a real growth rate of 4.5 to 5.0 percent. If outlays fall short of those estimates by $7 to $10 billion, as seems probable, real growth next year is more likely to be in the 4.0 to 4.5 percent range. Moreover, it appears that the principal risks for next year are on the downside--even if there is no Federal expenditure shortfall. Interest rates may rise more than allowed for; business investment may display less strength than assumed; or the personal saving rate may continue to climb.

Growth is most likely to be weakest in the latter half of the year, when the effect of the jobs program in the fiscal stimulus package will be wearing off. Without some additional fiscal stimulus beginning around the middle of next year, economic growth is likely to slow appreciably in late 1978. Unemployment will then stop declining and could begin creeping up again.

It is virtually certain that Congressional action on tax reform will not proceed swiftly enough for the entire package to be enacted by mid-1978. The House might be able to agree by that time on tax reduction in the bill; but if elements of tax reduction were separated from the tax reform aspects of the bill, the prospects of getting meaningful reform measures enacted later on would be seriously jeopardized.

We believe that if economic circumstances warrant, we should ask the Congress to provide a decrease in withholding for the second half of 1978. This would be a reduction of half the size applying in 1979 in the case of the rate cuts and personal credit contained in the tax reform package, which would then be finalized in the tax reform bill before the end of the year. Assuming passage of the full tax reform package in late 1978, the 1-year reduction would be replaced smoothly by the permanent tax reform in 1979.

Barring some very bad surprises in the economic data that will be released over the next 3 weeks, it would be premature to call for a 1978 tax reduction when the tax reform package is sent up to the Congress. Depending on how the economy does in the next 3 to 4 months, and the economic and budgetary outlook at that time, it may be desirable to include such a recommendation in the January budget message.

If you agree there is at least a significant possibility that a 1978 tax cut may be needed, this idea must be referred to in the tax reform message as a preparatory measure. (The economic reporters are sure to ask whether we can wait until 1979 for the first steps of the tax reduction/reform.)

The Balance of Risks

If economic activity in 1980-81 is weaker than now anticipated, there are few risks with the proposed tax program. Should additional stimulus be called for after 1979, there is ample time to propose it.

On the other hand, it is appropriate to review what would happen if the economy turns out to be stronger than anticipated. Postponement of some of the tax reductions or other restrictive measures would be politically very difficult.

The CEA has investigated in detail the balance of risks from unanticipated economic events, and its best estimate, based on only a modest amount of optimism, is that the unemployment rate would fall to 5 percent by year-end 1980 and remain there in 1981 with the full tax reform package enacted.

The CEA believes there is a small chance--about one in five--that the private sector could be strong enough, in combination with the tax package, to push the unemployment rate down to almost 4 percent by 1981. Should that occur, it is highly likely that the rate of inflation would speed up significantly.

In short, on the best estimates of the CEA, the overall size of the package appears about right. But there is a small possibility that it might be necessary to take difficult restrictive actions in 1980 and 1981 to prevent economic overheating.

Conclusions as to Economic Factors

1. The proposed tax package has been carefully designed to give the appropriate stimulus in 1979. It will cut almost a full point off the unemployment rate and will add $35 billion to GNP in 1979. Without the tax cut there would be virtually no chance of a return to high employment by 1981.

2. There is about an even chance that there will be a lull in economic activity in the second half of 1978. As the storm signals become clearer, it may be desirable to make the proposed personal tax cuts retroactive with a 1-year cut for the second half of 1978. It is not recommended that any announcement of this be made at this point. Rather, it is recommended that both the form of cuts and public announcements leave the door open for a January announcement.

3. The fight against inflation will not be won or lost here. The program may add approximately 1/2 point to the average annual inflation rate over the 1978-81 period.

4. Overall, then, the tax proposal is about the right size and has the right timing. The only concern is that there is a small chance that the tax reductions--in combination with unanticipated strength in private demands--could

Balanced budget?

take us beyond full employment and into the inflationary danger zone in 1980 and 1981. Taking the fiscal steps to deal with that problem would not be easy, but the risk is small and is bearable.

V. Other Contingencies

Two more contingencies are dealt with here:

(1) The possibility that Congress may eliminate or delay some of the revenue gains while acting promptly on the revenue reductions, and

(2) The problem of the timing of Congressional committee actions if this bill is to be completed next year.

Propensity of the Congress to Delay Revenue Gains

Tax reforms are always difficult for the Congress to enact. The groups which they adversely affect devote a major effort to forestall the reforms and they usually assert dire consequences if the action is taken. The effect of this is that Congress frequently does not enact all of the tax reforms advocated by an Administration, even though subsequent events may show that, viewed as a whole, they do not have the adverse effects that those looking at segments of the recommendations assert.

The problem, therefore, is how to deal with the possibility that Congress may be anxious to enact all, or almost all, of the tax reductions proposed by the Administration but reject many of the tax reforms proposed by it.

The best way of dealing with this problem is to emphasize in your presentation and the Treasury presentation this fall that the tax reduction proposals are contingent upon the adoption of the tax reform proposals and that if less revenue is raised through tax reform the Administration will propose scaled down tax reductions. In this connection, it would also appear desirable to privately and publicly urge Chairmen Ullman and Long to consider the tax reform proposals first and then give the Administration an opportunity to propose a scaled down version of tax reductions if the tax reform proposals do not bring in about as much revenue as originally proposed. ha!

Timing of Committee Action

Tax reform legislation requires a major commitment on the part of the Congress to complete action in a year. Of the major tax revision bills which have been enacted in recent years, only the Tax Reform Act of 1969 was completed in a single year. This was accomplished only because the two committees (in that case especially the Finance Committee under Senator Long) committed themselves in advance to action by a certain time; that is, completion of a hearing by a specified date, markup of the bill by a specified time, and House or Senate action by a specified time. This is a matter which needs to be worked out carefully not only with the committee chairmen but with the leadership of the two houses as well.

Complicating the problem of obtaining passage of the tax reform proposals in 1978 is the fact that the Ways and Means and Finance Committees are also the committees which we are asking to enact major welfare reform legislation, important social security legislation and possibly next year to consider major health insurance legislation. With this type of agenda specific commitments are needed as to the timing of the various actions.

Because of the heavy work scheduled for these committees next year, it would appear highly desirable to obtain an agreement from the Chairman of the Ways and Means Committee to hold the committee's hearings on the tax reform bill this fall. Chairman Ullman has committed himself to 2 weeks of hearings in October if the tax message comes up in the week beginning October 3. This would enable the Ways and Means Committee to commit itself to finish its hearings on the proposals next January (from the 17th to the end of the month). It would also present you and other members of the Administration with the opportunity this fall to make a series of public statements in effect answering some of the negative reaction which is almost sure to come from the committee hearing this fall.

Along with a specific commitment from Chairman Ullman to hold 2 weeks of hearings this fall, it would appear desirable to:

1. Obtain a commitment from him to complete the hearings in January.

2. Obtain a commitment from him that the markup of the bill would be completed by the end of February.

3. Obtain a commitment from Chairman Ullman and Speaker O'Neil that the bill would be passed by the House in March.

4. Obtain a commitment from Senator Long that if the House completes action on the bill in March the Finance Committee will complete its hearings in April.

5. On the basis of the schedule set out above, obtain a commitment that the Finance Committee will complete its markup of the bill in May so the bill can be brought to the Senate floor in June.

The above schedule actually is somewhat faster than is needed to secure passage of the tax reform program next year, but a schedule of this type appears desirable since even with the greatest cooperation there tends to be slippage.

VI. Views of Other Agencies

The Treasury Department has made an extensive effort to obtain the tax reform views of other agencies within the Executive Branch. We have consulted with: Department of Agriculture, Department of Commerce, Department of Energy, Department of Health, Education and Welfare, Department of Housing and Urban Development, Department of Interior, Department of Justice, Department of Labor, Department of State, Department of Transportation, Federal Home Loan Bank Board, National Credit Union Administration, Veterans' Administration and Small Business Administration.

Many of the agencies affected by the tax reform proposals have furnished us with written comments. These comments are summarized at appropriate locations within the option papers. In addition, we have attached the entire responses as an appendix.

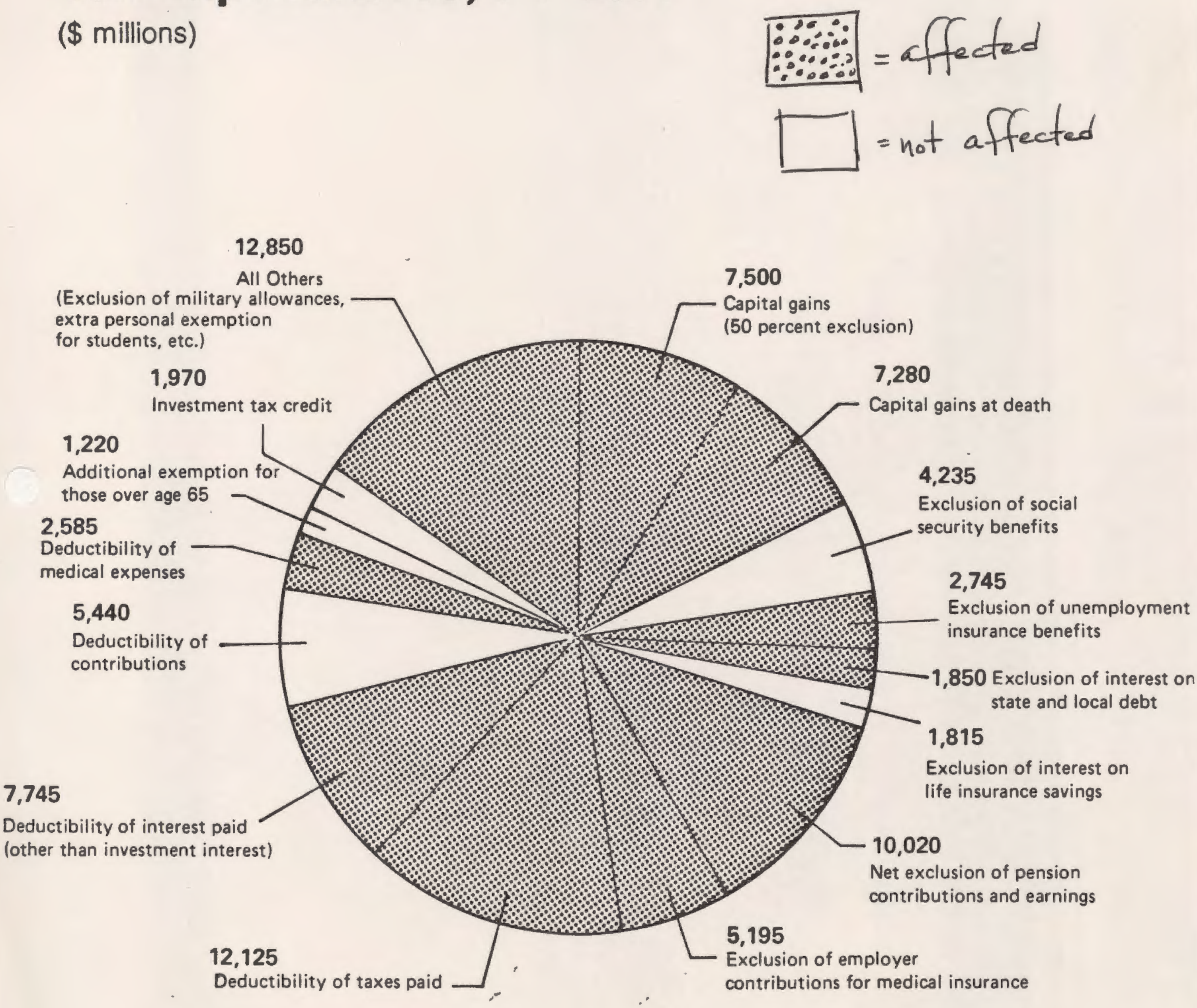
In developing the tax reform option papers, we have worked closely with the Council of Economic Advisers and the Domestic Policy staff. Their ideas are presented prominently throughout the nine option papers, and the CEA views are developed especially in Option Paper No. IX relating to business tax reductions and in the economic and budgetary portions of this overview. The Commerce Department also offered extensive comments with respect to Option Paper No. IX, and their views are presented at some length within that paper.

Charts

Chart 1

Revenue Cost of Major Individual Tax Expenditures, FY 1977

($ millions)



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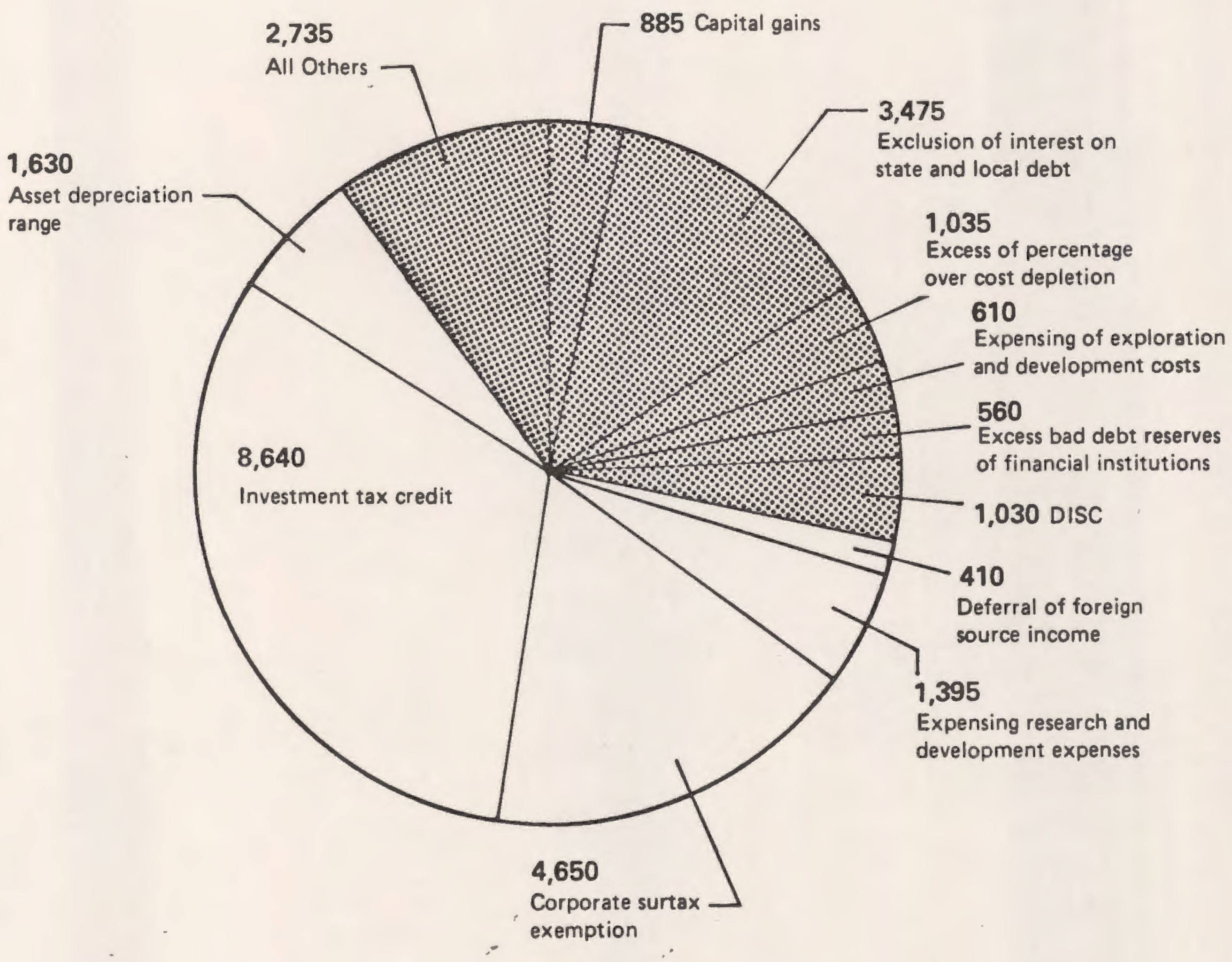
Office of Tax Analysis

September 12, 1977

Chart 2

Revenue Cost of Major Corporate Tax Expenditures Fiscal Year 1977

($ millions)



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Office of Tax Analysis

September 12, 1977

Chart 3

Tax Reform Program: Effective Individual Tax Rates --Taxes as a Percent of Expanded Income, 1976 Level of Income.

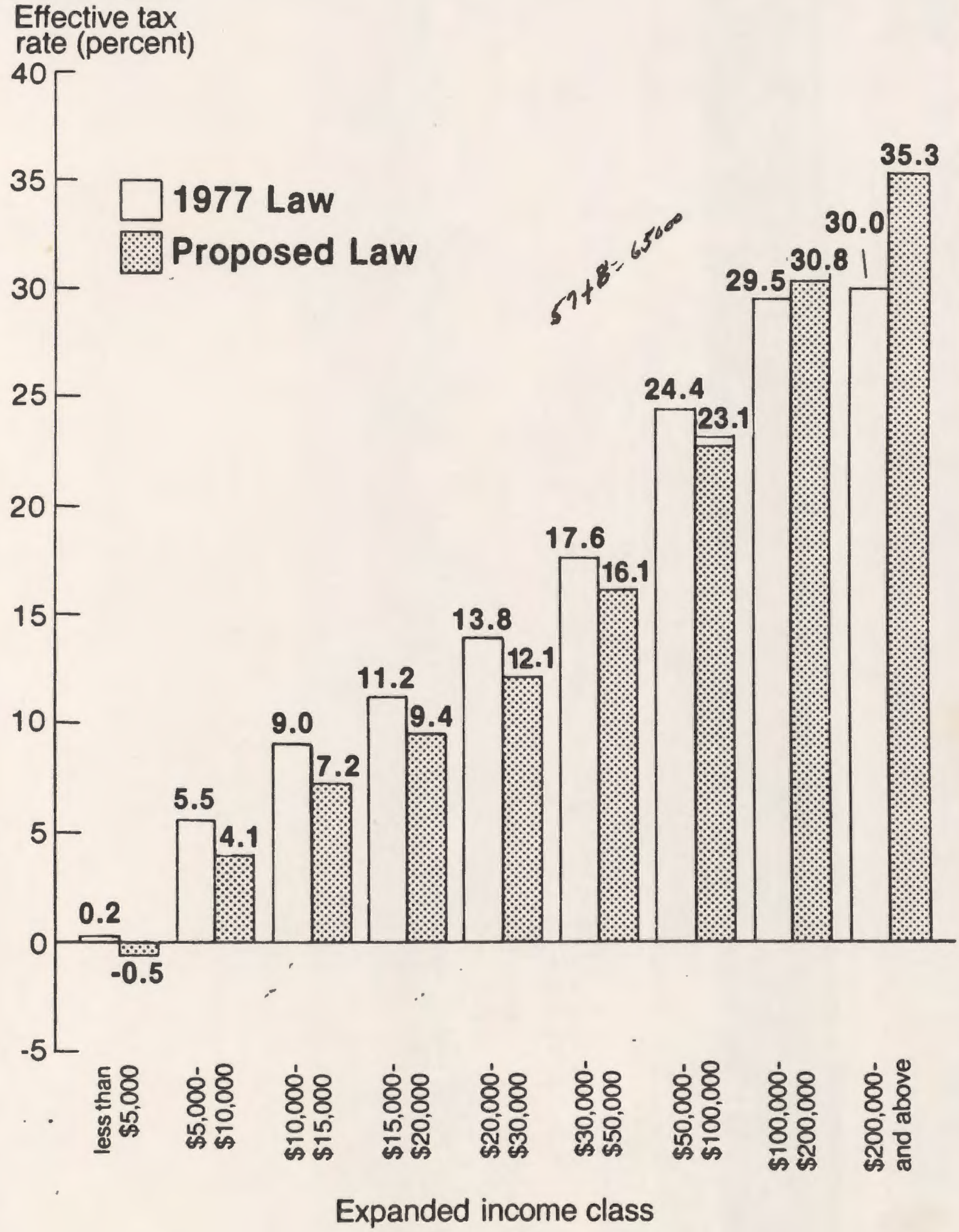


Chart 4

Comparison of Effective Tax Rates Under 1977 Law and Under the Proposed Law, Assuming Corporate Tax Imputed to Individuals, by Expanded Income Class

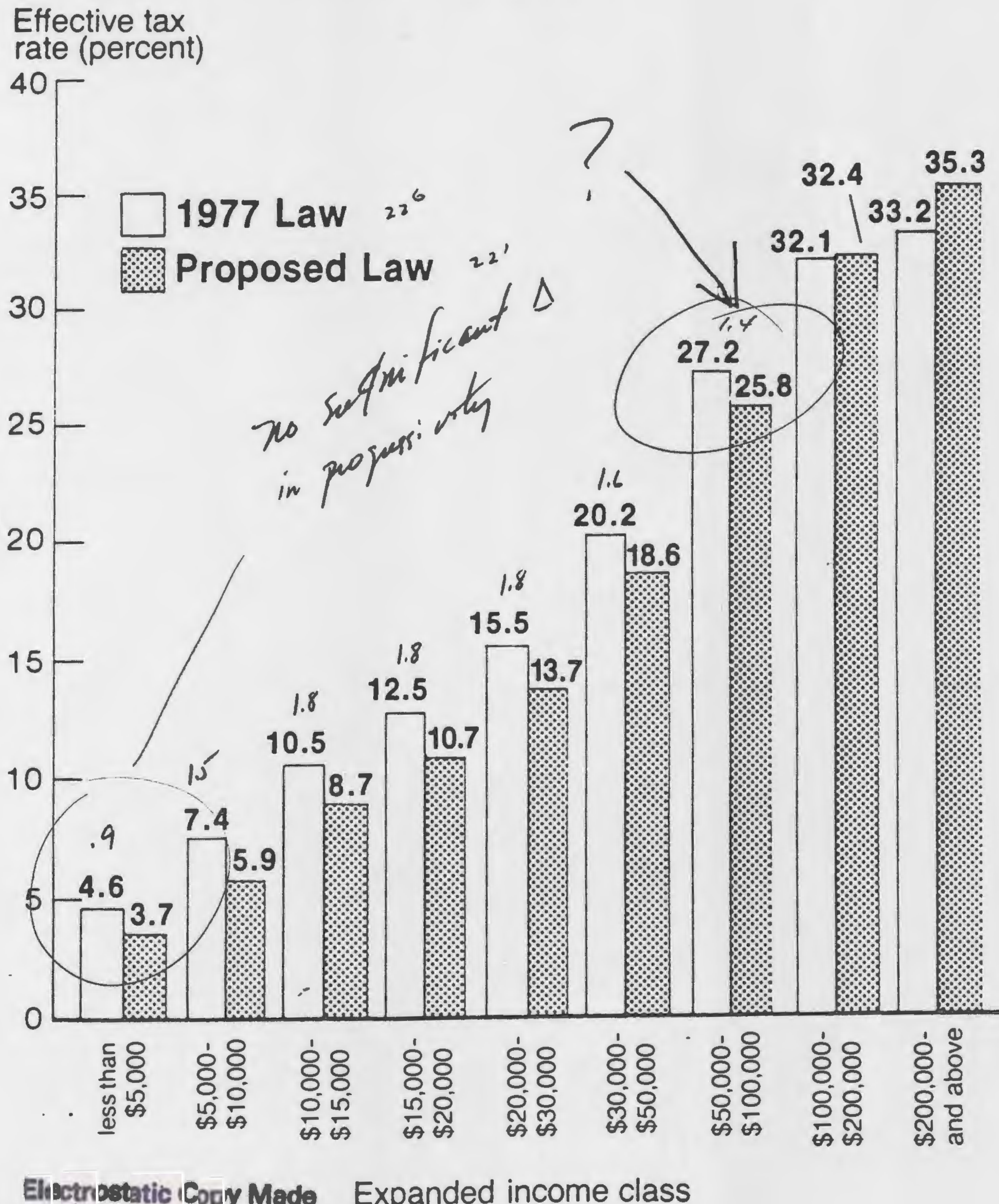


Chart 5

Frequency Distribution of Returns by Effective Tax Rate, in Selected Expanded Income Classes

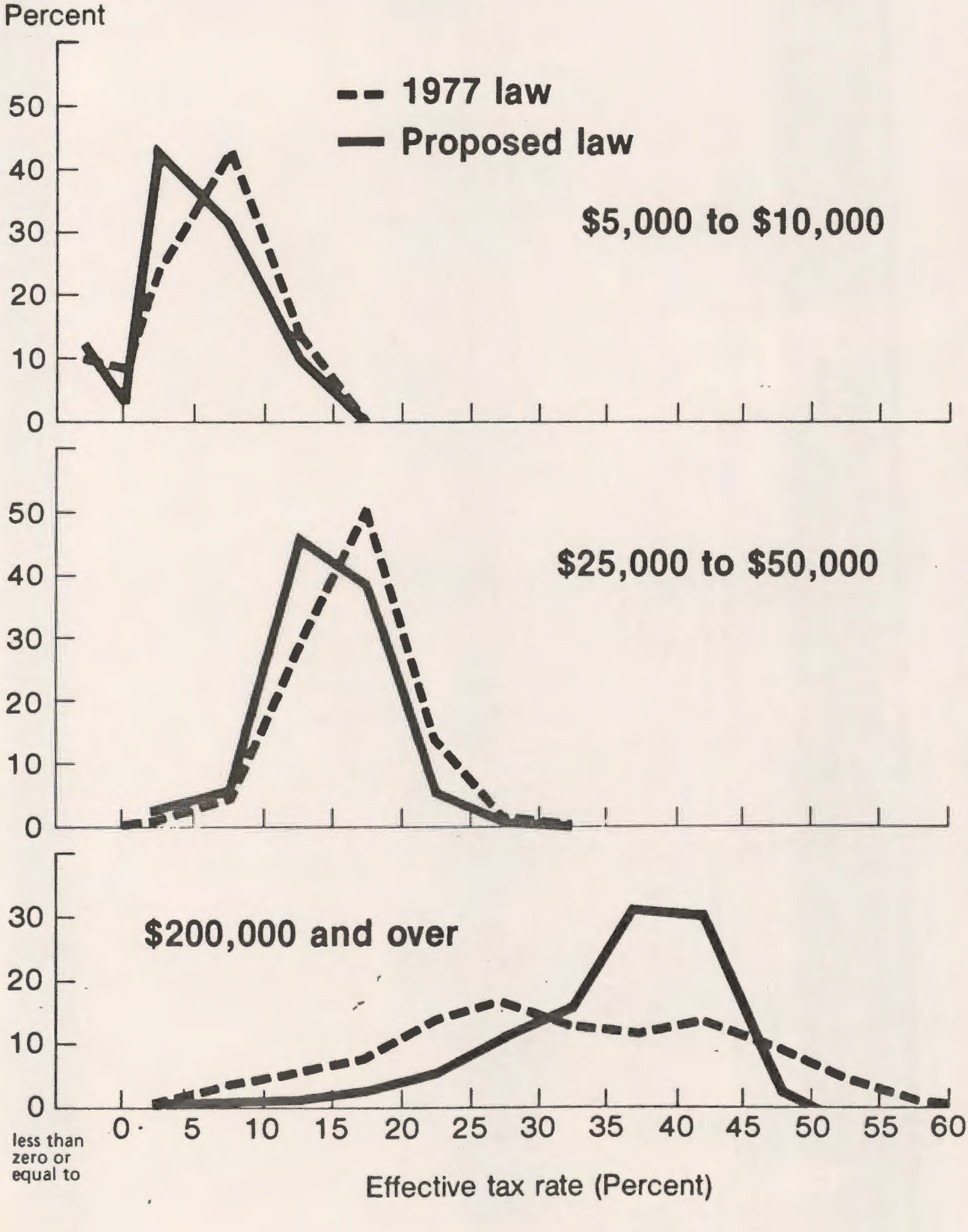
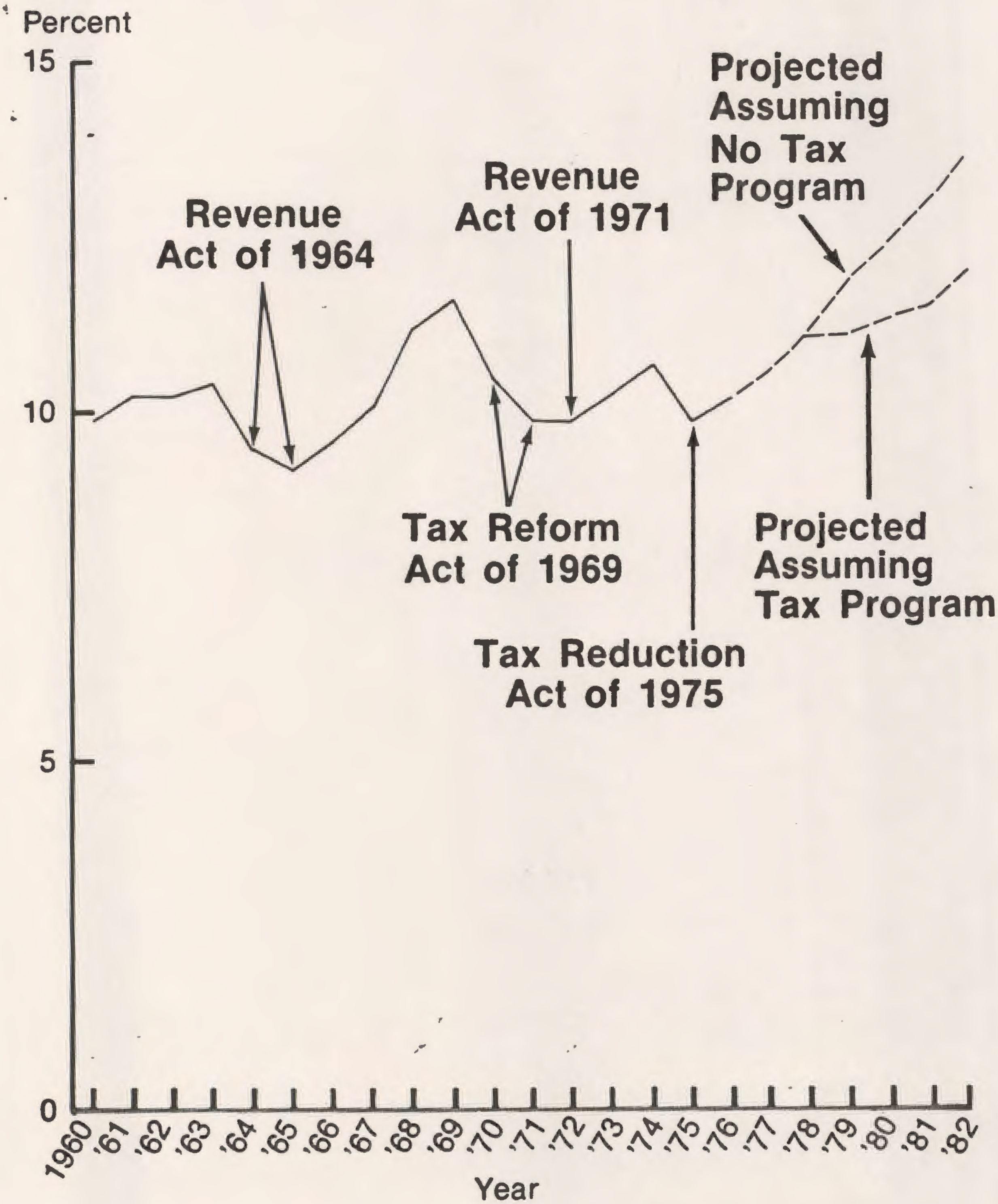


Chart 6

Individual Income Taxes as a Percent of Personal Income, 1960-1982

(Arrows Identify Years of Major Effect of Significant Tax Legislation)



Tables

Table 1

The Direct Effect of the Tax Reform Proposals
on Tax Expenditure Items, Individual Only
Fiscal Year 1977

($ millions)

	Tax expenditure budget	Change due to tax reform proposals	Percent change
Capital gains:			
50 percent exclusion	$ 7,500	$ -4,522	-60.3%
Transferred at death	7,280	-1,954	-26.8
Exclusion of social security	4,235	--	--
Exclusion of unemployment benefits	2,745	-268	-9.8
Exclusion of interest on state and local debt	1,850	-491	-26.5
Exclusion of interest on life insurance savings	1,815	--	--
Net exclusion of pension contributions and earnings	10,020	-40	-0.4
Exclusion of employer contributions for medical insurance	5,195	--	--
Deductibility of taxes paid	12,125	-3,175	-26.2
Deductibility of interest paid	7,745	-16	-0.2
Deductibility of contributions	5,440	--	--
Deductibility of medical expenses	2,585	-1,655	-64.0
Additional exemption for the over age 65	1,220	--	--
Investment tax credit	1,970	1/	--
Depreciation on buildings	585	-550	-94.0
Veterans benefits and services 2/	685	--	--
Exclusion of other employee benefits	885	-267	-30.2
Scholarships and fellowships and GI bill benefits	505	-215	-42.6
All other	10,190	-20	-0.2
Total	$84,575	$-13,173	-15.6%

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September 12, 1977

1/ The proposed business tax deductions would liberalize the investment credit.
2/ Excludes GI bill benefits.

Addendum: Under the broader program there would be additional changes of:
Exclusion of social security, -$800 million (-18.9%);
Exclusion of interest on life insurance savings, -$1,815 million (100.0%).

Table 2

The Direct Effect of the Tax Reform Proposals
on Tax Expenditure Items, Corporate Only
Fiscal Year 1977

($ millions)

	Tax expenditure budget	Change due to tax reform proposals	Percent change
Capital gains	$ 885	$ -755	-85.3%
Exclusion of interest on state and local debt	3,475	-497	-14.3
Excess of percentage over cost depletion	1,035	-690	-66.7
Expensing of exploration and development costs	610	-114	-18.7
Excess bad debt reserve	560	-369	-65.9
Exemption of credit unions	165	-130	-78.8
Expension of research and development expenses	1,395	--	--
DISC	1,030	-1,030	-100.0
Deferral of foreign source income	410	--	--
Corporate surtax exemption	4,650	--	--
Investment credit	8,640	-- */	--
Asset depreciation range	1,630	--	--
Depreciation on buildings	310	-267	-86.1
Other	2,260	-150	-6.6
Total	$27,055	$-4,002	-14.8%

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September 18, 1977

*/ The proposed business tax reductions would liberalize the investment tax credit.

Addendum: Under the broader program there would be additional changes of:
Recapture of DISC, $775 million assuming the change starts in 1981.
Deferral of foreign source income, -$410 million.

Table 3

Summary of Revenue Effects of Treasury Tax Reform Proposals

($ millions)

	Full-year effect (1976 levels)	Fiscal Years			
		1979	1980	1981	1982
Proposal primarily affecting individuals:					
Tax reform proposals	11,768	6,754	11,227	14,729	18,033
Tax reduction proposals ..	-27,052	-16,294	-32,222	-43,276	-50,937
Net tax reduction	-15,284	-9,540	-20,995	-28,547	-32,904
Proposal primarily affecting business:					
Tax reform proposals	4,017	950	2,745	4,507	5,982
Capital formation proposals	-6,555	-7,978	-11,378	-13,923	-14,297
Net tax reduction	-2,538	-7,028	-8,633	-9,416	-8,315
Total, individual and business proposals:					
Tax reform proposals	15,785	7,704	13,972	19,236	24,015
Tax reduction proposals ..	-33,607	-24,272	-43,600	-57,199	-65,234
Net tax reduction	-17,822	-16,568	-29,628	-37,963	-41,219
Additional items in broader programs:					
Primarily affecting individuals	1,667	132	979	1,142	1,323
Primarily affecting business	772	248	644	1,171	1,596
Total	2,439	380	1,623	2,313	2,919

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Office of Tax Analysis

September 22, 1977

Table 4

Revenue Effect of Tax Reform Provisions Primarily Affecting Individual Income

($ millions)

	Full-year effect (1976 levels)	Fiscal Years 1979	1980	1981	1982
$250 credit and reduced tax rates	-25,364	-15,980	-29,933	-40,803	-48,265
Working spouse exclusion	-1,688	-314	-2,289	-2,473	-2,672
Capital gains taxation:					
Tax as ordinary income	3,735	272	2,321	4,310	5,93[illegible]
Property transferred at death	1,645		154	397	692
Itemized deduction changes:					
Repeal gasoline tax deductions	542	520	800	887	986
Repeal sales tax deductions	1,518	1,456	2,240	2,487	2,761
Repeal miscellaneous tax deductions	345	330	509	564	626
Deductions for medical and casualty expenses	1,276	1,159	1,761	1,919	2,092
Interest expense deductions	14	14	22	25	28
Repeal political contributions deductions	3	2	5	4	4
Tax shelters:					
Individual real estate shelters	439	13	129	328	532
Tax credits to 90 percent of tax before credits	38	8	57	64	72
Exclusions affecting the elderly:					
Tax credit for elderly	-11	-2	-14	-15	-16
Employee exclusions:					
Taxation of unemployment benefits	275	32	227	221	220
Group term life insurance	166	85	190	198	205
Group legal insurance	40	10	19	30	46
Nondiscrimination rule for health and group term life plans	30	15	33	35	35
Tax qualified retirement plans:					
Limit on benefits, contributions, etc. .	10	4	10	10	10
Death benefit exclusion	30	14	32	33	33
Other exclusions:					
Scholarships, fellowships, GI bill benefits	170	49	357	380	402
Withholding on interest income	1,356	2,760	2,245	2,518	2,820
Taxable bond option	147	13	130	334	547
Total	-15,284	-9,540	-20,995	-28,547	-32,904
Additional items in broader program:					
Taxation of social security and railroad retirement benefits	616	126	926	1,036	1,159
Taxation of interest element of annuity and insurance contracts	1,051	6	53	106	164
Total, additional items in broader program	1,667	132	979	1,142	1,323

Office of the Secretary of the Treasury
Office of Tax Analysis

September 22, 1977

*Less than $500 thousand.

Table 5

Revenue Effect of Provisions Primarily Affecting Business Income

	Full-year effect (1976 levels)	Fiscal Years 1979	1980	1981	1982
	(..................	$ millions	....		)
Tax Reform Proposals					
Small business	-10	-1	-6	-10	-14
Foreign:					
Repeal DISC	870	--	145	1,136	1,966
Tax 50 percent of shipping income	100	45	100	100	100
Prohibit uniform apportionment rule	--	--	--	--	--
Corporate capital gains	700	153	483	825	1,077
Expensing of reforestation costs ..	-53	-32	-73	-80	-89
Financial institutions:					
Bad debt reserves:					
Commercial banks	200	104	235	237	141
Mutual savings banks and savings and loans	169	22	76	160	283
Credit unions	126	62	148	175	204
Depletion on hard minerals	734	36	123	224	338
Minimum tax on intangible drilling costs	114	--	173	199	228
Amend entertainment deductions	750	508	1,184	1,300	1,414
Corporate real estate shelters	267	23	100	205	314
Corporate family farm accounting ..	30	18	33	18	8
At risk limitation	20	12	24	18	12
TOTAL, tax reform	4,017	950	2,745	4,507	5,982
Capital Formation Proposals					
Relief from double taxation 1/ -- allowing shareholders to treat as withholding a portion of corporate tax aqual to 20 percent of gross dividends	-2,463	-527	-3,862	-4,271	-4,627
Corporate rate reductions -- 2 percentage point cut in corporate rate (1 point on the top rate, 1 point on the lower rates)......	-2,652	--	-1,062	-3,457	-4,967
Investment credit changes:					
10 percent credit for structures:					
Industrial	-638	-1,193	-1,030	-1,265	-1,412
Utility	-441	-798	-614	-675	-741
Increase limit to 70 percent of tax liability in 1980 and 90 percent thereafter	-71	--	-317	-687	-466
Temporary increase in investment credit by 3 points in 1978 and 1979, 2 points in 1980 and 1 point in 1981	--	-5,418	-4,362	-3,324	-1,694
Full credit for pollution abatement facilities	-90	-42	-99	-116	-122
Depreciation based on work in progress	-200	--	-32	-128	-268
TOTAL, capital formation	-6,555	-7,978	-11,378	-13,923	-14,297
Grand total, tax reform and capital formation	-2;538	-7,028	-8,633	-9,416	-8,315
Additional items in broader program:					
Recapture of DISC	359	--	70	538	901
Elimination of deferral of foreign source income	413	248	574	633	695
Total, additional items in broader program	772	248	644	1,171	1,596

Office of the Secretary of the Treasury
Office of Tax Analysis

September 22, 1977

1/ Includes the repeal of the dividend exclusion.

Table 6

Burden Table:
Joint Return with Two Dependents

Expanded Income Class ($000)	Average Tax 1977 Law	Average Tax Under Treasury Proposal	Average Tax Change	Percentage Change
Less than 10	9	-76	-85	-925
10 to 15	867	492	-375	-43
15 to 20	1,739	1,357	-382	-22
20 to 30	3,117	2,682	-435	-14
30 to 50	6,287	5,582	-705	-11
50 to 100	16,336	14,984	-1,352	-8
100 to 200	40,885	40,854	-31	*
200 and over	127,666	152,087	24,421	+19

* Less than 0.05 percent

check 10-50%
#60T-50% table

Political problem

Office of the Secretary of the Treasury
Office of Tax Analysis

September 13, 1977

Table 7

The Impact of the Tax Package on Economic Performance

	1978	1979	1980	1981
The economy without the tax package				
Unemployment rate	6.3	6.2	5.8	5.8
Real growth	4.4	4.3	4.3	3.4
The economy with the tax package				
Unemployment rate	6.3	5.7	5.1	5.1
Real growth	4.6	5.6	5.0	2.9
Net benefits/costs of package				
Increased employment (thousands)	40	500	1,000	1,000
Additional output (billion of dollars 1977 prices)	3	30	45	35
Increase in per capita after-tax income (1977 prices)	10	120	190	200
Increase in inflation rate	0.0	0.2	0.6	0.7
Increased business investment (billion, 1977 prices)	2	11	20	19

Office of the Secretary of the Treasury
Office of Tax Analysis

September 16, 1977

Source: Council of Economic Advisers

SUMMARY

Summary of Tax Reform Option Papers

This memorandum briefly summarizes the contents of the accompanying Treasury option papers on tax reform.

The memorandum indicates whether the Treasury, the Council of Economic Advisers (CEA), and the Domestic Policy Staff (DPS) agree on the proper handling of an item. Where we disagree the essence of our disagreement is set out. In addition, the positions of other agencies are indicated where their views may be of special concern.

Practically every proposal (except those for personal tax reductions) will be difficult to get through Congress and will be opposed by various interest groups. Accordingly, the memorandum does not make separate reference to the controversy each item will arouse except where the controversy will be particularly intense and opposition from particular interest groups severe.

The right-hand column of the memorandum sets forth the revenue gain or loss projected for each item proposed for inclusion in the program (a) when fully phased in (at 1976 levels of income) and (b) for fiscal year 1981.

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
Option Paper No. I: Personal Tax Reductions		
1. $250 personal credit. (p.1) It is recommended that the existing $750 exemption and general tax credit be replaced by a per person credit which would be phased in to reach $250 by 1981. We agree on this item. (Note: if the Administration position is upheld in the energy legislation, there will be an additional per capita rebate of the revenues from the wellhead tax.) HEW is concerned with the starting point of taxation.	Simplification & cut Included in rate cuts	
2. Rate cuts. (p. 5) It is recommended that the present 14 to 70 percent rate structure be replaced by rates which range from 10 to 50 percent (with the 50 percent rate taking effect at $70,000 on a joint return). In order to reduce the "singles" penalty, the rate schedules for single persons, married couples, etc. would be adjusted to ensure that a single taxpayer never paid more than 15% more taxes than a married couple with the same income, compared to 20% under present law. The reduction in marginal rates would be phased in over a three-year period. We agree on this item.	? -25.5	-40.8
3. Marriage penalty. (p. 9) It is recommended that in order to reduce the marriage penalty for two-earner couples, the lesser earning spouse be given a tax deduction equal to 10% of income up to a maximum deduction of $600. We agree on this item.	- 1.7	- 2.5

	Revenue Effect Gain + Loss – ($ billions) Full-year effect (1976 income)	 Fiscal year 1981
Option Paper No. II: Itemized Deductions		
1. State and local taxes. (p. 1) It is recommended that the deductions for sales, personal property, gasoline, and miscellaneous taxes be eliminated. The deductions for income taxes and real property taxes would be continued without change. We agree on this item.	+ 2.4	+ 3.9
2. Medical expenses and casualty losses. (p. 6) It is recommended that the separate deductions for medical expenses and casualty losses be combined into a new "extraordinary expense" deduction which would be available for those expenses only to the extent that they exceed 10% of adjusted gross income. We agree on this item. (HEW wants to postpone changes in medical expenses until national health insurance is provided.)	Can predict possible modification later + 1.3	+ 1.9
3. Mortgage interest and interest on consumer loans. (p. 8) Treasury and CEA recommend that a $10,000 limitation be placed on the (presently unlimited) deductions for interest on mortgages and consumer loans. DPS recommends that instead of a separate limitation, these interest deductions be included in the existing $10,000 limitation on non-business investment interest so that there would be a single limitation for all forms of personal and investment interest. Both recommendations would leave the present $8 billion tax expenditure for personal interest essentially unchanged, with the		

	Revenue Effect Gain + Loss - ($ billions) Full-year effect (1976 income)	Revenue Effect Gain + Loss - ($ billions) Fiscal year 1981
Treasury proposal picking up about $14 million in revenue and the DPS proposal adding about $25 million. Treasury believes that a separate limitation is required to avoid the charge that those taxpayers who use up the present investment interest limitation are being denied a deduction for their mortgage interest. DPS believes that a single limitation is simpler and fairer in that it does not provide separate $10,000 interest deductions for those top-bracket taxpayers who both invest heavily in securities <u>and</u> own large or multiple homes.	*	*
4. <u>Political contribution deduction</u>. (p. 10) It is recommended that the deduction for political contributions be repealed but that the credit be retained. <u>We agree on this item</u>.	*	*
5. <u>Charitable contributions</u>. (p. 11) It is recommended that no change be made in this area. <u>We agree on this item</u>.	----	----

<u>Option Paper No. III: Capital Gains and Losses</u>

1. <u>Capital gains during life</u>. (p. 1) It is recommended that capital gains realized during life be taxed as ordinary income. The new treatment for capital gains would be phased in over a three-year period. <u>We agree on this item</u>. The taxation of capital gains like other income will be vigorously opposed by the business and financial community and would probably be the single most controversial proposal in the program.	+ 3.7	+ 4.3

---

* Less than $0.05 billion

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
2. Inflation indexing for capital gains. (p. 2) Treasury recommends that an inflation adjustment be provided for property held for more than 10 years. Treasury believes that this adjustment is necessary (a) to deflect Congressional and financial community sentiment for full indexing of capital gains if these gains are to be taxed as ordinary income and (b) to facilitate passage of this major reform. CEA and DPS are opposed to the Administration recommending an inflation adjustment for capital gains because: (a) it would be inequitable to the small savers and wage-earners who would not get an inflation adjustment; (b) it would be a major policy error to introduce indexing in any form into the tax system; and (c) indexing would be inconsistent with the simplification goal which is a major reason for eliminating the capital gains preference in the first place.	- 0.3	- 0.3
3. Venture capital rule. (p. 2) It is recommended that in order to defuse the argument that elimination of the capital gains preference will injure venture capital in small business, a special tax credit be provided for venture capital stock held for more than 10 years. We agree on this item.	Included in capital gains	
4. Capital losses. (p. 7) Capital losses would be allowed in full against ordinary income except that losses on marketable securities generally would be limited to gains from marketable securities plus $10,000 (as opposed to the present $3,000) a year. We agree on this item.	Included in capital gains	

	Revenue Effect Gain + Loss - ($ billions) Full-year effect (1976 income)	Fiscal year 1981
5. Capital gains on transfers at death or by gift. (p. 9) It is recommended that, subject to certain exceptions, the appreciation in property occurring after December 31, 1976, transferred at death or by gift be subject to tax. We agree on this item. The taxation of capital gains at death will be strongly resisted, and by proposing it we take the risk that Congress might not only reject our proposal but repeal the carryover basis rule which it adopted in 1976. don't understand	+ 1.6	+ 0.4
6. Taxation of capital gains transferred to charities. (p. 11) It is recommended that for most of what is now capital gains property no change be made in present law, which permits an income tax deduction for the full amount of the appreciation of such property given to charity (but capital gains on charitable transfers at death will be exempted from tax under item 5 and, accordingly, there will be no income tax deduction for these transfers). This will increase the preference presently granted to charitable gifts. We agree on this item.	*	*
7. Timber industry. (p. 13) It is recommended that the timber industry be permitted to expense (as opposed to capitalize as under present law) regeneration and reforestation costs. This would partially offset the adverse effect upon the industry of taxing timber sales as ordinary income. We agree on this item.	- 0.1	- 0.1

* Less than $0.05 billion

	Revenue Effect Gain + Loss - ($ billions) Full-year effect (1976 income)	Fiscal year 1981
<u>Option Paper No. IV: Tax Shelters and Preference Income</u>		
1. <u>Real estate depreciation</u>. (p. 1) It is recommended that the rules for depreciation of real estate be tightened but Treasury has not tightened the rules as much for multi-family housing and through 1981 does not apply these rules to low-income housing. CEA believes no special rules should apply to housing. HUD believed that earlier rules presented could reduce the rate of return on housing tax shelters from about 13% to 10% and divert some equity capital from housing to other industries. Treasury modified its recommendations to meet this point.	+ 0.7	+ 0.5
2. <u>Accounting by agricultural corporations</u>. (p. 4) It is recommended that all corporate farms with gross receipts of more than $1 million and not taxed like partnerships be required to use accrual (as opposed to cash) accounting. <u>We agree on this item</u>.	*	*
3. <u>Percentage depletion for hard minerals</u>. (p. 6) It is recommended that percentage depletion for hard minerals be phased out over a ten-year period. <u>We agree on this item</u>. It is opposed by Interior. DOE does not want percentage depletion removed for coal. This proposal also will be vigorously opposed by the mineral industries.	+ 0.7	+ 0.2

* Less than $0.05 billion

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
4. <u>Percentage depletion for oil and gas</u>. (p. 7) DPS recommends phasing out percentage depletion for oil and gas over the five-year period beginning in 1985. CEA recommends a 15-year phase-out beginning in 1985. (Percentage depletion is presently available only to the independent producers and is being reduced to 15% by 1984.) Treasury recommends against doing anything in this area at this time in view of the present energy requirements. CEA and DPS believe that it would be inconsistent to argue for the elimination of depletion for hard minerals and leave percentage depletion for oil and gas untouched and that percentage depletion for oil and gas is an unwarranted preference which adds little to production and benefits one of the wealthiest groups in the country. Treasury believes that there will be ample time between now and 1984 to propose the elimination of percentage depletion for oil and gas and that its inclusion in the program now would unnecessarily irritate the independent producers and the Congressmen who represent them. (DOE agrees with Treasury.)	7 + 0.6	+ 0.0
5. <u>Intangible drilling costs</u>. (p. 7) It is recommended that intangible drilling costs for both individuals and corporations be classified as preference income and included in the minimum tax. <u>We agree on this item</u>. This may be criticized by the oil interests as a reversal of our proposal in the energy bill.	+ 0.1	+ 0.2

6. <u>Financial institutions</u>. (p. 11) It is recommended that the special bad debt deduction for commercial banks be eliminated, the 40% bad debt deduction for savings and

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
loan associations be phased down to 20% over 5 years, and credit unions be subject to tax to the same extent as savings and loans. We agree on this item. This proposal will be vigorously opposed by the banking industry and credit unions.	+ 0.5	+ 0.6
7. Minimum tax, etc. (p. 14) It is recommended that the minimum tax be retained in essentially its present form but strengthened. In addition, the investment tax credit would be allowed to offset only 90% (as opposed to 100% at present) of the first $25,000 of tax liability. Tax shelters would be reduced by extending the "at risk" limitations and developing proposals to tax some limited partnerships as corporations. We agree on this item.	sufficient ? + 0.1	+ 0.1

Option Paper No. V: Transfer Payments and Treatment of the Elderly

1. General treatment of transfer payments. (p. 1) It is considered, but not recommended, that all transfer payments above $20,000 for single persons and $30,000 for married couples be included in the tax base. We agree that this item should not be included.	----	----
2. Social security and railroad retirement benefits. (p. 3) It is recommended that (a) no action be taken with respect to social security payments and that they continue to be exempt from taxation and (b) that the portion of railroad retirement benefits which are the equivalent of private pensions be taxed as income like other		

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
private pensions. DPS opposes (b) because it believes the railroad unions may have relied on this tax treatment in their negotiations. Treasury believes these railroad pension benefits are income and should be taxed like all other private sector pensions.	*	*
3. Unemployment compensation benefits. (p. 6) It is recommended that a portion of unemployment compensation benefits be included in taxable income for single individuals with income above $15,000 and married couples above $20,000. We agree on this item.	+ 0.3	+ 0.2
4. Veterans and Black Lung benefits. (pp. 7,8) It is recommended that no action be taken with respect to these payments and that they continue to be exempt from taxation. We agree on this item.	----	----
5. Scholarships, fellowships and GI bill benefits. (p. 10) Treasury recommends that amounts received for scholarships, fellowships, or GI bill benefits be included in taxable income except to the extent that they represent allowances for tuition and fees. DPS opposes this recommendation because distributional tables indicate that about 90% of the benefits of this preference go to individuals with incomes of less than $10,000 and this would be a "red flag" item which could adversely affect our entire program. Treasury believes that the provision of living expenses should be subject to tax like any other income. This proposal will be opposed by education institutions and veterans groups. Veterans Administration opposes this treatment for GI benefits.	+ 0.2	+ 0.4

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* Less than $0.05 billion

	Revenue Effect Gain + Loss - ($ billions) Full-year effect (1976 income)	Fiscal year 1981
6. <u>Credit for the elderly and retirement income credit for public employees</u>. (p. 12) It is recommended that the credit for those above 65 be modestly increased and that the retirement income credit for public employees under age 65 be eliminated. <u>We agree on this item</u>. ?	*	*
<u>Option Paper No. VI: Employee Fringe Benefits</u>		
1. <u>Group term life insurance</u>. (p. 1) It is recommended that employer-paid premiums on the first $25,000 of group term life insurance coverage be tax-free to employees (as opposed to premiums on the first $50,000 under present law). <u>We agree on this item</u>.	+ 0.2	+ 0.2
2. <u>Medical and disability insurance</u>. (p. 2) It is recommended that employer-paid medical and disability insurance be required to be nondiscriminatory. <u>We agree on this item</u>.	*	*
3. <u>Group legal insurance</u>. (p. 3) Treasury recommends that employer-paid group legal insurance be taxable to the employees. DPS opposes this recommendation because it believes that: group legal insurance helps low and middle income persons get adequate legal services, is similar to tax-exempt employer-paid medical services, and because this recommendation will be unnecessarily provocative to the unions who just succeeded in getting legislation passed last year exempting these benefits from taxable income. Treasury believes that the provision of legal services is a form of income and that this legislation is bad tax policy which should be repealed before it becomes a model for other employer-paid expenses. ?	*	*

* Less than $0.05 billion

Item	Revenue Effect Gain + Loss - ($ billions) Full-year effect (1976 income)	Fiscal year 1981
4. Qualified retirement plans and death benefits. (pp. 5,8) It is recommended that a series of changes be made in the provisions affecting retirement plans, for the general purpose of mitigating those aspects of these plans which permit discrimination in favor of officers, shareholders, and higher paid employees of companies and high-bracket taxpayers generally. In addition, it is recommended, for similar reasons, that employee death benefits be eliminated. We agree on these items.	*	*
5. Entertainment expenses. (p. 9) Treasury recommends that business deductions be disallowed for entertainment facilities (yachts, club dues, etc.). DPS agrees but further recommends that business deductions also be disallowed for theater and sporting event tickets, golf fees, and first-class airfare. DPS believes that tickets, fees, and first-class airfare are as symbolic of "expense account" living as club dues and that all the reasons for denying deductions for club dues apply as well to these items. Treasury believes that the inclusion of tickets and first-class airfare in our program will provoke the opposition of the theater, sporting event and airline industries.	+ 0.8	+ 1.3
6. Meals. (p. 9) Treasury recommends that 50 percent of otherwise allowable deductions for business meals be denied. DPS recommends that deductions for business meals be limited to the lesser of a flat dollar amount per meal (e.g., $15) or 50 percent of the cost of the meal. Treasury believes that its proposal is reasonable in disallowing in effect		

* Less than $0.05 billion

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
the cost of an individual's own meal (where two are involved) but allowing the deduction for the cost of the individual's business client. DPS believes that there is no justification for asking taxpayers generally to subsidize 50 percent of the cost of $50 to $100 meals (and even greater expenses when more than two persons are involved) and that the 50 percent rule will be regarded as allowing one-half of what most people regard as an unjustified deduction. Either recommendation will be vigorously opposed by the restaurant industry and its unions.	Included in Entertainment Expense	
7. Foreign conventions. (p. 10) It is recommended that the deduction of expenses for foreign conventions be denied unless it is reasonable for the meeting to be held outside the United States, and that the deduction for qualified conventions be increased from 100 percent of government per diem at present to 125 percent. We agree on this item.	*	*
Option Paper No. VII: Tax Treatment of Interest		
1. Withholding on interest and dividend payments. (p. 1) It is recommended that payors of taxable interest be required to withhold and deliver to the Government 20 percent of the interest payments they would otherwise make. Similar treatment is provided in the business option paper for dividends. We agree on this item. This proposal will be vigorously opposed by the banking industry.	+ 1.4	+ 2.5

* Less than $0.05 billion

	Revenue Effect Gain + Loss - ($ billions) Full-year effect (1976 income)	 Fiscal year 1981
2. <u>Interest buildup on life insurance and annuity contracts</u>. (p. 3) DPS recommends that the interest earned on the savings element of cash value life insurance and on annuity contracts be taxed to the policyholder. (This would apply only to insurance and annuities issued <u>after</u> the date of the statute.) Treasury opposes this recommendation. DPS believes that: this interest buildup is the same as interest earned on savings accounts and should be taxed the same (otherwise saving through insurance policies will continue to be given preferred tax status over saving through bank savings accounts); if this recommendation is not accepted, insurance and annuity contracts may become the new tax shelter of the future; and if the interest element remains free of tax, life insurance companies will continue to have a relative competitive advantage over commercial and savings banks. Treasury notes (a) that interest on life insurance, unlike savings accounts, is not available to the holder unless he borrows against or surrenders the policy and (b) that the proposal would be opposed by all insurance agents and by many policyholders. A middle ground on which DPS and Treasury might be able to agree would be the taxation of the interest buildup on annuity and insurance coverage in excess of $100,000 per individual if this could be administered. ? This item will be vigorously opposed by the insurance industry.	+ 1.1	+ 0.1
3. <u>Taxable bond option</u>. (p. 6) It is recommended that State and local governments be given the option of choosing between the issuance of conventional tax-exempt municipal bonds and taxable bonds which will receive a		

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
subsidy from the U.S. Treasury for 35 to 40 percent of the interest cost. <u>We agree on this item</u>. Some State and local government organizations will oppose this proposal.	+ 0.1	+ 0.3
4. <u>Industrial development bonds</u>. (p. 9) Treasury recommends that the interest on industrial development bonds issued for all private beneficiaries (except for certain "small" issues and low-income housing bonds) be subject to tax. CEA agrees with this recommendation but would also subject the "small issues" and low-income housing bonds to tax. CEA believes that these exemptions are no more justified than the rest of this provision. Treasury believes that the "small issue" exemption is greatly favored by State and local development authorities and that allowing these issues to remain in the tax-exempt market is a reasonable compromise position. This treatment for housing bonds is favored by HUD.	Included in taxable bond option	

Option Paper No. VIII: International Taxation

1. <u>Elimination of DISC</u>. (p. 1) It is recommended that the DISC tax benefits be reduced by 50 percent in 1980 and eliminated for 1981 and subsequent years. <u>We agree on this item</u>.	+ 0.9	+ 1.1

2. <u>Taxation of accumulated DISC profits</u>. (p. 1) CEA and DPS recommend that the accumulated DISC profits, the tax on which has been deferred, be subject to tax in equal installments over a 10-year period. Treasury opposes this recommendation because it may

	Revenue Effect Gain + Loss - ($ billions) Full-year effect (1976 income)	Fiscal year 1981
lead to accounting problems for some corporations which have not established reserves adequate to pay their ultimate tax liability on accumulated DISC income. CEA and DPS note that: DISC was created to defer, not exempt, income from tax; foregoing the legal right to tax DISC profits would cost the U.S. Treasury $6 billion in tax revenues; and that the accounting problems can be handled. Commerce opposes this recommendation.	+ 0.6	+ 0.6
3. Deferral. (p. 6) CEA and DPS recommend that the deferral of taxation on the income of U.S.-controlled foreign subsidiaries be eliminated. Treasury opposes this recommendation because it believes that elimination of deferral (a) would adversely affect the competitive position of U.S. multinationals in foreign countries, (b) would depart from the tax practice of all other countries with respect to unrepatriated earnings, and (c) would not increase domestic investment or jobs. CEA and DPS believe that deferral (a) provides a tax incentive for U.S. corporations to invest abroad rather than at home and is, accordingly, inconsistent with our concern for domestic capital formation and job creation and (b) encourages financial manipulation by multinationals to avoid U.S. taxation, at a considerable cost to the U.S. Treasury. Labor supports this recommendation; State and Commerce oppose it.	+ 0.4	+ 0.6
4. Taxation of foreign shipping. (p. 10) It is recommended that one-half of the income from any voyage to, or from, the U.S. by ship or aircraft be subject to tax and that certain other changes be made. We agree on this item. The Maritime Administration has questions about this.	+ 0.1	+ 0.1
5. State taxation of foreign-based multinationals. (p. 14) It is recommended that in taxing the income of foreign-based multinational corporations doing business within		

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
the United States, our various States use the accounting method generally accepted in international practice (the method used by the U.S. Government) in determining the amount of income of the multinationals allocable to doing business within the States. <u>We agree on this item</u>. This proposal will be opposed by the tax administrators of some States.	*	*
<u>Option Paper No. IX: Business Tax Reductions</u>		
1. <u>Revenue effect</u>. (p. 3) The tax reform program will close business preferences raising approximately $4-$5 billion when fully phased in at 1976 levels of income. Treasury and CEA jointly recommend proposed tax reductions primarily affecting business income amounting to $6.6 billion (excluding the temporary increase in the investment tax credit referred to below) at 1976 levels of income and expanding to approximately $14 billion by 1981.		
2. <u>Specific proposals</u>. (p. 5) Treasury, CEA, and Commerce recommend business tax reductions as follows:		
a. Partial integration via the "gross up" and credit method through a withholding tax credit of 20 percent for shareholders. (This involves a "gross up" or increase in the shareholder's rate of return of 25 percent. DPS believes that if you wish to support integration, the "<u>gross up</u>" of the dividend should be limited to 20 percent, which would save $600 million at 1976 levels of income and $900 million in FY 1981.)	? - 2.5	- 4.3

* Less than $0.05 billion

	Revenue Effect Gain + Loss - ($ billions)	
	Full-year effect (1976 income)	Fiscal year 1981
b. A reduction in the top corporate rate from 48 to 46 percent and in the bottom rates (which apply to the first $50,000 of corporate income) from 22 to 21 percent and from 20 to 19 percent. -2%	- 2.7	- 3.5
c. Extension of the investment tax credit (ITC) to industrial structures. bldgs	- 1.1	- 1.9
d. Temporary increase in the ITC by 3 percentage points in 1978 and 1979, 2 points in 1980, and 1 point in 1981.		- 3.3
e. An increase in the ITC limit from 50 percent to 90 percent of tax liability.	- 0.1	- 0.7
f. Full 10 percent ITC for pollution control facilities. now?	- 0.1	- 0.1
g. Permitting depreciation to begin on work in progress on a utility project (as opposed to when the project is actually placed in service as at present).	- 0.2	- 0.1
3. Small business. (p. 17) In addition to the reduction in the bottom corporate rates which will benefit small business, Treasury recommends for small business: simplification and liberalization of the ADR system of depreciation, reduction in the accumulated earnings tax, and liberalization of the Subchapter S rules. We agree on this item. The Small Business Administration would like other changes as well.	*	*

* Less than $0.05 billion

OPTIONS

THE WHITE HOUSE

WASHINGTON

September 23, 1977

MEMORANDUM FOR: THE PRESIDENT

FROM: STU EIZENSTAT Stu
BOB GINSBURG

SUBJECT: Option Paper No. I: Personal Tax Reductions

1. Personal Credit. We support Treasury's recommendation that a personal credit which would phase in to reach $250 by 1981 replace the existing $750 exemption and general tax credit. The personal credit tends to be favorable to low income families with children. Some tax reformers (e.g., Joe Pechman) would argue that since we are cutting taxes anyway, a better method of doing so would be through deeper cuts in tax rates. Under that approach, a somewhat lower credit of $230 or $240 would permit lower tax rates at the bottom of the income scale. Rate cuts tend to be more neutral with respect to family size.

2. Rate Structure. We support Treasury's recommendation that the present 14-70 rate structure be replaced by marginal tax rates which would range from 10 to 50 (with the 50 rate taking effect at $70,000 for a joint return, as compared to $44,000 under present law). The rate structure for our program has been the subject of considerable discussion and negotiation between us and Treasury:

   (a) Treasury had originally proposed a 12-50 structure with the 50 rate taking effect at $80,000 on a joint return. We felt that this rate structure was not sufficiently progressive and had the serious political disadvantage of cutting rates 20 points (or 2/7) at the top and only 2 points (or 1/7) at the bottom.

   (b) We proposed a 10 to 50 structure with the 50 rate taking effect at $60,000; as compared with Treasury's 12-50 proposal (which had net tax reductions for all income classes up to $200,000), our rate

What is treasury's objection to this?

structure would have provided for about $1 billion more in tax reductions for low and middle income taxpayers and $1 billion less in tax reductions for upper income taxpayers (while still leaving net tax reductions for the $50,000 - $100,000 income class).

(c) Treasury then proposed a 10-50 rate structure but with the 50 rate still taking effect at $80,000; this rate structure, while having the improved appearance of going to 10 at the bottom, would have resulted (as compared with Treasury's 12-50 proposal) in only small additional reductions for low income taxpayers and would have "financed" these reductions by small increases in taxes for middle income taxpayers. We argued that the rate structure was not much better than the original Treasury proposal and that we could not support giving a minor break to the $10,000 taxpayer at the expense of the $20,000 taxpayer.

(d) Treasury, at our request, then came back with a 10-50 rate structure with the 50 rate taking effect at $70,000. This Treasury proposal is a considerable improvement: as compared to the original Treasury 12-50 proposal, it provides for about $350 million more in tax reductions for low and middle income taxpayers and $350 million less in tax reductions for upper income taxpayers. As indicated above, we now support the proposed Treasury rate structure.

(e) You can see the effect of this rate structure (and the entire reform program) on the average family by looking at Table 6 in the overview paper.

While there will still be a good-sized tax reduction for upper income taxpayers in the $50,000 - $100,000 class, this reduction will be smaller in percentage terms than the reductions in lower income classes. Treasury believes that some tax reductions, even in the upper income classes, may be politically necessary in order to secure passage of our controversial capital gains proposals.

3. Marriage Penalty. We support Treasury's recommendation to reduce the "marriage penalty" for two-earner couples by giving the lesser earning spouse a tax deduction equal

to 10% of income up to a maximum deduction of $600. This proposal would cost $1.7 billion and would be centered mostly on middle income families. An alternative might be to spend somewhat less (e.g., $800 million to $1 billion) to reduce the marriage penalty and put the difference into rate cuts throughout the income scale. We do not recommend this alternative.

Would proposal require an additional tax table?

Tax Reform Option Paper No. I

Personal Tax Reductions

The tax reductions proposed that affect individuals are: a personal credit, rate cuts, and the working spouse exclusion. These reductions are closely related to the tax increases proposed. Rate cuts are needed to offset the tightening of capital gains, itemized deductions, and other preferences primarily benefitting individuals.

(1) Personal credit in place of personal exemption and general tax credit.

Present Law.--Presently there is a personal exemption of $750 for each taxpayer or dependent. 1/ A general tax credit is also provided equal to $35 per exemption, or 2 percent of taxable income up to a credit of $180, whichever is the greater.

Proposal.--The personal exemption and the general tax credit would be replaced with a $250 personal credit. The credit, by itself, reduces taxes for low income families and increases taxes for high income families. The $250 credit provides reductions of $4.9 billion almost entirely to families with incomes under $20,000 and tax increases of $3.5 billion largely to families with incomes over $20,000, for a net loss of $1.4 billion. The tax increases in the upper brackets are much more than offset, however, by proposed rate reductions.

Phase in of Change.--The credit would be phased in at the level of $230 for 1979, $240 for 1980, and $250 for 1981 and thereafter.

Revenue Estimate.--The $250 tax credit reduces revenues by $1.4 billion. A $240 credit would be revenue neutral and the $230 credit would increase revenues by $1.8 billion. Even the lower credits of $230 and $240 provide significant tax relief for low-income families.

1/ Additional $750 exemptions are provided for taxpayers over age 65 or blind.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

° Having both a personal exemption and a tax credit to differentiate tax liabilities by family size adds unnecessary complexity to the tax law. The tax system should include either one or the other, but not both.

° Moving to a per capita credit instead of a deduction will better accommodate per capita energy rebates.

° Per capita credits tend to be more favorable to low-income families with children.

° The $250 credit is more likely to ensure that the tax-free levels of income are near or above the break-even points for the welfare system.

° The table below illustrates for a four-person family the tax exempt level of income, the break-even point under the proposed cash assistance program, and the poverty level.

Comparison of Exempt Levels of Income and Poverty
Levels for 4-Person Families

Year	Exempt Level of Income*	Welfare Break-Even Level**	Poverty Level***
1977	$ 7,200	--	$ 6,193
1978	7,200	$ 9,072	6,565
1979	9,200	9,607	6,952
1980	9,422	10,086	7,299
1981	9,644	10,600	7,613

Office of the Secretary of the Treasury
Office of Tax Analysis

September 22, 1977

* Existing law assumed for 1977 and 1978. For 1979-81, the proposed personal credit and rate reductions are assumed. The credit is phased in: $230 for 1979, $240 in 1980, and $250 in 1981. Rate cuts are phased in in 1979, 1980, and 1981. Excludes the effect of the earned income credit.

What is US average?

** Maximum Federally subsidized break-even level assuming State supplementation.

*** Estimated for nonfarm families.

Con.--

What would be tax rates c̄ Higher exemption to be equivalent?

- Much the same result as the proposal could be obtained by converting the general credit under present law to an exemption and adding it to the $750 exemption. Then larger rate reductions would be in the lower income brackets than provided by the Treasury proposal.

- Taxpayers generally are more accustomed to the personal exemption than they are to the credit. The exemption, since it is a deduction against income, rather than a deduction against tax, is a larger number and appears more generous (even though in actuality it may be less).

- The substitution of the credit for exemption is less generous to those with large families and substantial income.

HEW Comment.--HEW is concerned as to the starting levels of taxation. Under their program the basic benefits phase out over a span of income above the poverty level. They desire, in order to minimize disincentives to work and to avoid the administrative complications of states "paying" the taxes of welfare recipients, that the tax level begin at the end of the phase out of welfare payments. HEW understood that the starting tax levels in 1979 would be those provided by the $250 credit and assumed that there would be discretionary changes made in the starting level of taxation after 1979 by congressional action which would in general correspond with the price rise during that period of time. Therefore, HEW favors a higher credit in 1981.

Assuming the credit is $250 in 1981, the overlap between upper levels of welfare and starting levels of taxation will be $803 for a couple with one child in the case of married joint return households. For the "typical" family of four the overlap is $956. The situation is worse in the case of a single parent family with children because of the lower standard deduction and slightly higher tax rates for "head of household" tax units. The tax overlap is $1,877 for a household with one child, and $2,268 for a household with three children.

HEW is exploring an alternative that would lower the welfare system's breakeven--for example, approximately $400 lower in the case of a family of four. HEW recommends that the personal credit in the tax system be increased to $300 in 1981 by changing the rebate of the oil equalization tax revenues from a "per taxpayer" credit to a per capita credit, so it could be added to the general credit. In addition, HEW would like to increase the standard deduction for heads of households from $2,200 to $3,200.

CEA Comments.--In designing the welfare reform package, it was assumed (1) that the Treasury package had a $250 credit and the wellhead tax would go on top of that, and (2) that the level of real benefits would be maintained between 1978 and 1981. At the same time, it was realized that these decisions would have to be reviewed in light of the final disposition of the wellhead tax in the Congress.

Therefore, CEA recommends that the tax package contain a $250 credit, without any reference to the wellhead tax. If the wellhead tax is passed in accordance with the Administration proposals, or as passed by the House, then the wellhead tax credit could be added on top of the $250 credit. If the wellhead tax is siphoned off into other uses, then we will have to rethink how much can be afforded for additional per capital credits to minimize the overlap between the tax and welfare systems.

Treasury Comment.--The two changes sought by HEW would have a revenue loss of about $7.8 billion. Most of this cost might be recovered by using the oil equalization tax revenues for this purpose but to the extent they are so used they cannot be used to reduce the overall cost of the tax reform program below the $36 billion level for 1981.

In addition, increasing the standard deduction for heads of households to $3,200 would provide substantially better tax treatment for divorced couples with children than for married couples with children. It should also be noted that the earned income credit under their proposal will not be phased out in 1981 for a family of four until an income level in excess of $17,000 is reached. Even at the income level of $15,000 there would be a credit of about $275 which would offset about a quarter of the tax otherwise due.

We believe this problem cannot be worked out until after it becomes clear how the Senate will act on the energy bill. This is basically an issue which then needs to be determined on the basis of its economic and budgetary effects.

Treasury Recommendation.--A $250 personal credit should be phased in between 1979 and 1981.

Agree _______

Disagree _______

Want to discuss further _______

(2) Rate cuts

Present Law.--Under present law statutory tax rates range from 14 percent to 70 percent. There are four rate schedules as shown below:

Rate schedule	Percent of tax returns	Relationship to joint return liability
Single returns	37.7	Not more than 120% tax of joint return
Married filing jointly	53.9	----
Married filing separately	2.3	Tax brackets half as wide as joint return
Head-of-household	6.0	Rates halfway between joint and single returns
TOTAL	100.0	

Proposal.--Reduced marginal tax rates of 10 to 50 percent would be provided for each of the four schedules. The rate schedule for single persons would ensure that a single taxpayer never paid more than 15 percent more taxes than a married couple with the same income, compared to 20 percent under present law. (The tax rate schedules are shown in the appendix of these option papers together with effective rate tables, burden tables and income distribution tables.)

Phase in of Change.--The reduction in tax rates could be phased in in 1979, 1980, and 1981. When fully phased in, the 50 percent rate would apply to taxable income above $70,000 for married couples filing jointly and $54,000 for single individuals.

Revenue Estimate.--The reduction in rates would reduce revenues by $24.0 billion when fully phased in.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

- Without significant rate reductions, particularly to a top rate of 50 percent, it would be politically difficult to tax capital gains as ordinary income as well as to provide other base broadening changes.
- The reduction of the bottom rate from 14 percent to 10 percent is the same percentage reduction as the reduction of the top rate from 70 percent to 50 percent.
- Without significant rate reductions it would be politically difficult to reduce itemized deductions.
- The rate reductions also are needed to offset the tax increases for high income families resulting from replacing the personal exemption and general tax credit with the personal credit.
- Progressivity in the tax system is increased by the combination of the credit and the proposed rate structure. In the context of the entire program, low income families receive large tax reductions while the average tax rate is actually increased for families with incomes of over $100,000.
- A significant rate reduction is necessary to keep individual income taxes close to the overall effective rate of 10 to 11 percent of personal income, a relationship maintained within a range of about 1 percentage point since 1945.
- A significant rate cut and personal credit increase are needed to stimulate economy sufficiently to approach full employment by 1981.

- A 50 percent top rate permits repeal of the maximum tax--a significant simplification measure.

Con.--

- This rate reduction program is costly in that the revenue loss at 1976 levels of income is $24 billion and will be substantially more at 1981 income levels.

- The tax rate cuts will be criticized because they are greater at the upper end of the rate schedule than at the bottom end. The 70 percent rate would be reduced to 50 percent while the 14 percent rate would be reduced to 10 percent. (This, actually is the same percentage reduction in both cases and in addition there also is the credit which reduces taxes further in the bottom brackets and elimination of the capital gains preference which increases taxes in the upper brackets).

- The decreases in the itemized deductions which are offset with rate reductions benefit not only those who claim itemized deductions but also those who claim standard deductions as well. Therefore, the net advantage even with the rate cut in reality does shift somewhat towards those claiming the standard deduction.

Treasury Recommendation.--Marginal tax rates should be reduced in three steps to 10 to 50 percent. The 50 percent rate would apply at $70,000 for a married couple and $54,000 for a single individual.

Agree ______

Why not $60,000?

Disagree ______

Want to discuss further ______

(3) Working Spouse Exclusion

Present Law.--Under present law, a couple's taxes may increase if they marry where both have income. This increase in taxes is the "marriage penalty." However, if only one has income or their income is disparate (e.g., split 90 percent-10 percent) there is a tax decrease upon marriage.

Proposal.--The personal credit and the lower tax rates will reduce the marriage penalty. To further reduce the marriage penalty, a special deduction for a working spouse would be provided. It would be 10 percent of the first $6,000 of earnings of the spouse with the lower earnings. The maximum deduction would be $600.

Revenue Cost.--The working spouse deduction would reduce revenues by $1.7 billion.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

- Present law results in an overtaxation of two-earner families. These families are overtaxed as compared to both single persons and one-earner families.

- Two-earner families are subject to a work disincentive--or marriage disincentive--created by the tax law.

- Providing a special deduction for two-earner families reduces the marriage penalty without at the same time increasing the penalty against single persons; that is, without increasing the amount of additional taxes a single person pays compared to the taxes paid by a one-earner family with the same income. (Also, the new rate schedules reduce the single penalty to no more than 15 percent of the tax paid by a married couple with the same level of income.)

- The two tables at the end of this paper show the reduction in the marriage penalty achieved by the combination of the $250 personal credit, the rate cuts and the working spouse exclusion, assuming the family income is split 70-30 or 50-50 (the latter is unlikely). The working spouse exclusion in the case of the 70-30 percent split will reduce the marriage penalty to about $100 or less for family incomes up through $30,000 a year. Even for married couples with $50,000 of family income the marriage penalty is reduced by half.

Con.--

- A working spouse exclusion adds complexity to tax return preparation. This requires one additional computation even for those taking the standard deduction.

- Questions may be raised as to whether the present "marriage penalty" really prevents marriages and whether removing this penalty is worth the $1.7 billion of revenue loss involved.

- Among two adult families, with equal total incomes, this provision favors those with two earners. Thus for a family with $20,000 of earned income, if that income is all earned by one earner, there is no working spouse exclusion; if there are two earners, with the one with the lesser earnings having at least $6,000 of earnings, this two-earner family has $600 less of taxable income.

Treasury Recommendation.--A special working spouse deduction should be provided to reduce the marriage penalty.

How much more ~~tax~~ complexity

Agree ______

Disagree ______

Want to discuss further ______

Marriage Penalty Assuming Income Split 70-30

The Additional Amount of Tax a Couple with a Joint Return Would Pay Over What It Would Pay if Both Persons Could File Single Returns

Total Family Income	Present Law	$250 Tax Credit and Rate Cuts	$250 Tax Credit, Rate Cuts, and 10% Deduction
$ 5,000	$ -43	$ 0	$ 0
10,000	141	24	-30
15,000	176	192	107
20,000	274	215	77
30,000	430	233	65
50,000	1,188	760	544

Office of the Secretary of the Treasury
Office of Tax Analysis

September 22, 1977

Note: In all tax calculations deductible expenses are assumed to be 16 percent of income.

Marriage Penalty Assuming Income Split 50-50

The Additional Amount of Tax a Couple with a Joint Return Would Pay Over What It Would Pay if Both Persons Could File Single Returns

Total Family Income	Present Law	$250 Tax Credit and Rate Cuts	$250 Tax Credit, Rate Cuts, and 10% Deduction
$ 5,000	$ 0	$ 0	$ 0
10,000	204	256	166
15,000	277	222	108
20,000	463	284	146
30,000	565	228	60
50,000	1,910	1,200	984

Office of the Secretary of the Treasury
Office of Tax Analysis

September 22, 1977

Note: In all tax calculations deductible expenses are assumed to be 16 percent of income.

2

THE WHITE HOUSE

WASHINGTON

September 23, 1977

MEMORANDUM FOR: THE PRESIDENT

FROM: STU EIZENSTAT Stu
BOB GINSBURG

SUBJECT: Option Paper No. II: Itemized Deductions

1. Areas of Agreement. We support Treasury's recommendations to:

   (a) eliminate the deductions for sales, personal property, gasoline, and miscellaneous taxes;

   (b) combine the separate deductions for medical expenses and casualty losses into a single new deduction with a 10% floor;

   (c) eliminate the deduction for political contributions but retain the credit; and

   (d) make no changes in the deduction for charitable contributions.

2. Mortgage Interest and Interest on Consumer Loans.

   (a) Treasury recommends that a $10,000 limitation be placed on the deductions for interest on mortgages and consumer loans. We recommend instead that these interest deductions be included in the existing $10,000 limitation on nonbusiness investment interest so that there will be a single $10,000 limitation for all forms of personal interest.

   (b) Our recommendation adopts the original Treasury proposal presented to you on this item. Treasury changed its proposal because it was concerned that the political charge would be made that under a single limitation taxpayers who had investment interest would be denied a deduction for their mortgage interest. This concern is misplaced. Our proposal would only affect the wealthy few who would use most or all of their $10,000 limit on investment interest and have none left for their home mortgage--but these persons probably don't need the mortgage interest deduction anyway. Neither the Treasury proposal (which would pick up about $14 million in revenue) nor our proposal (which would pick up about $25 million) would make any dent in the approximately $8 billion tax expenditure for personal interest.

(c) We believe that our recommendation is both simpler and fairer in that it does not provide $20,000 in interest deductions for those top bracket taxpayers who both invest heavily in securities and own large or multiple homes. (Even the single $10,000 limitation might be criticized by tax reformers as overly generous--it would cover homes with values up to $150,000.)

3. Overview of Treatment of Itemized Deductions.

(a) A curtailment of itemized deductions is important because it improves the progressivity of our tax system and furthers simplicity as well (by shifting taxpayers from itemizing to taking the standard deduction). The reform program recommended will leave essentially untouched the $8 billion tax expenditure for personal interest, the $9 billion expenditure for state and local income and real property taxes, and the $5.5 billion expenditure for charitable contributions. These items (except for state and local income taxes) are left untouched basically for political reasons.

(b) Alternative approaches (each of which would have severe political difficulties) would include:

Prob c̄ charitable institutions?

(i) a lower rate schedule for those who take the standard deduction (as proposed by Joe Pechman);

(ii) shifting from deductions to credits for mortgage interest, property taxes, and charitable contributions (as proposed by Senator Kennedy);

(iii) placing a floor under the deduction for charitable contributions; and

(iv) eliminating the deduction for interest on consumer loans.

In general, these approaches would either shift a large amount of the preference involved from upper income to low and middle income taxpayers or raise significant amounts of revenue:

(i) <u>Lower rate schedule for nonitemizers</u> (Joe Pechman's idea). This would have the effect of cutting down on the real value of all remaining itemized deductions; it could shift large numbers of taxpayers to the standard deduction. Treasury believes this would not be a cost-effective way of effecting that shift and would provoke severe opposition from the homeowner and charity interests, making the proposal politically infeasible.

(ii) <u>Shifting from deductions to credits</u>. This would be fairer to low and middle income taxpayers than the present deduction. Since the credits would be available for all taxpayers (not just those who itemize), the return form would have to <u>add a new line for each of these credits</u>. This proposal would probably help charitable institutions favored by low and middle income taxpayers (such as churches) and hurt those favored by upper income taxpayers (such as universities). Notwithstanding its greater equity, this proposal would again provoke severe opposition from the homeowner and charity interests.

?

(iii) <u>Floor on deduction for charitable contributions</u>. This proposal would permit the itemization of charitable contributions only to the extent they exceeded a given percentage (e.g., 3%) of income. It would constitute a direct assault on the preference for charitable giving, raise over $2 billion a year in revenue, and provoke the total opposition of all charitable institutions.

(iv) Eliminate deduction for interest on consumer loans. This would remove the tax preference for buying on credit rather than for cash. It would raise about $2.5 billion per year in revenue, largely from those middle and upper middle income taxpayers who itemize. It would be strongly opposed by all financial institutions (including credit card companies) which make consumer loans.

Why not include in $10,000 limit?

Tax Reform Option Paper No. II

Itemized Deductions

To reduce the number of itemizers and to achieve simplification for those itemizing their deductions, significant reductions in itemized deductions are proposed. The revenue gain from the proposed eliminations or reductions would be offset by general decreases in the tax rates. The proposed itemized deductions which would be affected and are discussed below involve (1) State and local taxes, (2) medical expenses and casualty losses, (3) personal interest deductions, and (4) deductions for political contributions. Also discussed below, but on which no recommendations are made, are charitable contribution deductions.

Eliminating many itemized deductions will--

- ease tax return preparation,
- reduce recordkeeping, and
- reduce audit and administration problems for both taxpayers and the IRS.

More persons will shift to the standard deduction if there are fewer itemized deductions. The 75 percent of the taxpayers who use the standard deduction today, if all of the changes proposed here are made, would increase to 83 percent.

(1) Taxes

Present Law.--The following State and local taxes currently are deductible:

income taxes, continue
real property taxes, continue
general sales taxes, no
personal property taxes, no
gasoline taxes, and no
miscellaneous taxes associated with income production no
(such as stock transfer taxes).

Proposal.--The special deduction for taxes would be denied for general sales taxes, personal property taxes, gasoline taxes, and miscellaneous taxes. The deduction for State and local income taxes and real property taxes would be continued without change.

Revenue effect.--The proposed repeal of deductions for gasoline taxes, sales taxes, personal property taxes and other miscellaneous taxes would result in a revenue gain of $2.4 billion. $1.5 billion of this is attributable to the sales tax deduction, $0.5 billion to the the gasoline tax deduction, and $0.3 billion to the deduction for personal property taxes and other miscellaneous taxes.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

- In the case of sales taxes, few taxpayers compute their actual sales tax deductions. Instead, they use IRS tables which vary the deduction by income level based upon IRS spending estimates. Since this is available to all itemizers, regardless of actual sales tax expenditures, approximately the same result for them can be obtained by lower rates, instead of these deductions.

- Since most States have sales taxes within the range of 3 to 5 percent, the denial of sales tax deductions treats most States and local governments about the same. In addition, the average deduction per taxpayer is small.

- Generally, State or local special excise taxes are not deductible for Federal tax purposes. Gasoline taxes are an exception to this rule.

- The deduction for gasoline taxes is usually claimed by the use of tables, and there are substantial errors made (generally in favor of the taxpayer) in determining these deductions. Here also the per taxpayer benefit is small.

- The deductibility of gasoline taxes runs counter to our energy goals (the House tax committee included the repeal of these taxes in the House version of the energy bill).

- Miscellaneous taxes (including personal property taxes) have no particularly strong basis for their allowance as itemized deductions and are generally a complication in tax return preparation, record-keeping and auditing. (Taxes incurred in the production of income would continue to be deducted or capitalized, as appropriate.)

- The deductibility of State and local income taxes is needed so the Federal and State or local income taxes can appropriately interact. Without deductibility of income taxes, the burden of State income taxes would increase substantially. In addition, income taxes, in a sense, should be deductible as a cost of earning the income. They usually are at least proportional, and the Federal government has generally favored encouraging the use of these taxes by the States. They do not cause appreciable recordkeeping problems.

- Deductibility of real property taxes have widespread support as an incentive to home ownership.

Con.--

- Many believe the deductibility of all of the major tax sources of States and local governments is necessary if any are to be deductible; otherwise it is suggested the Federal Government is favoring imposition by a State or local government of one form of tax over another.

- There are five States with no sales taxes. Denial of sales tax deductions gives their residents some advantages over residents of other States.

- It is contended that the denial of gasoline taxes discriminates against those who travel a long way to work.

- Automobile clubs will object to the denial of gasoline taxes as a deduction.

- Questions may be raised as to why property owners (through the deduction of real property taxes) should be favored over renters. Many in Congress favor a special deduction for renters to compensate them for this disadvantage.

Other Agency Comment.--No agency has commented adversely on this proposal.

Treasury Recommendation.--Itemized deductions would be denied for general sales taxes, gasoline taxes and miscellaneous taxes (including personal property taxes). However, deductions would be retained for income taxes and real property taxes.

Agree ✓

Disagree ________

Want to discuss further ________

Ceiling on real property deductions.--The Treasury was requested to comment on the possibility of a ceiling on real property taxes. It is assumed for this analysis that there could be a property tax limit of $6,000 but with no limit for property used in a trade or business or held as a rental property for investment purposes.

Revenue effect.--It is estimated that a $6,000 limitation on this deduction would result in a revenue gain of $97 million.

Discussion of the Issues.--The primary reasons for and against such a proposal are:

Pro.--

- Property tax payments are more in the nature of a discretionary use of income. Therefore, the rationale for deductibility for property taxes is weaker than for income and general sales taxes, which are more like forced reductions in income.

- The property tax deduction discriminates against renters who cannot deduct the property taxes included in their rental payments.

- The proposed $6,000 ceiling on the property tax deduction is sufficient to preserve a long-standing tax preference for the average homeowner, while placing a limit on the tax break available to individuals who own large homes or vacation homes.

° The deductibility ceiling will encourage States and localities to rely more heavily over time on income taxes, which are generally considered to be a more equitable source of revenue.

Con.--

° Property taxes vary widely over the United States, with the result that any property tax limitation will provide maximum deductions which, in terms of property values, vary drastically in different areas. Comparative tax rate data indicate that the amount of property tax liability in relation to value varies from 0.3 percent to 5.7 percent throughout the country with the average being about 2 percent. This means that the $6,000 limitation would on the average provide for the full deduction of taxes on a property worth $300,000. However, in other localities the $6,000 deduction would cover only a value of $105,000 while in still others it would cover a value up to $2 million.

° Any limitation on real property tax deductions would be viewed as an attack on the favored tax treatment for home ownership.

° At least a portion of the taxes on vacation homes would still be deductible, if they are held out for rent.

CEA Comment.--Cea believes that this provision makes good sense if we are attempting a comprehensive reform, but realizes it has serious political difficulties.

Treasury Recommendation.--In view of the widely varying property taxes imposed, the Treasury does not believe a fair limitation can be provided. It therefore recommends against such a limitation.

No limitation __________

Limitation __________

Want to discuss further __________

Who recommends?

(2) Medical Expenses and Casualty Losses

Present Law.--Currently, half of health insurance premiums (up to $150) are deductible outright; other medical expenses (including any additional health insurance premiums) are deductible to the extent they are in excess of 3 percent of adjusted gross income. Also included in the latter category are drugs to the extent that they exceed 1 percent of adjusted gross income.

Presently, damage to property from a casualty, such as a theft, fire, flood, hurricane or act of God, is deductible if it is in excess of $100.

Proposal.--The deductions for medical and casualty expenses would be combined and a new "extraordinary expense" deduction would be available for these medical and casualty expenses in excess of 10 percent of adjusted gross income. In the case of casualty losses, only the excess over $100 would be included in this computation. Medical insurance premiums would not be deductible as a separate item but would be treated the same as other medical expenses. Drugs also would be included in this category, and there would be no separate 1-percent floor.

Revenue Estimate.--It is estimated that this proposal would result in a revenue gain of approximately $1.3 billion a year.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

- The original purpose of the medical deduction was to allow relief for extraordinary medical expenses, but as medical costs have risen (relatively more than other costs), many taxpayers are now deducting medical expenses that are not extraordinary.

- Present law requires many taxpayers to compile detailed records of medical expenses which occur over widely varying periods during the year and under substantially different circumstances. Accurate records are difficult to keep. This suggests the desirability of requiring the keeping of these records only where the expenses are unusually large and have a serious impact on the taxpayer's ability to pay.

° Casualty deductions are a serious problem and interfere with the ability to pay only where they, in combination with medical expenses, are quite large.

° The deductibility of casualty losses enables high-income taxpayers to self-insure at low net cost through the tax system.

° It is difficult to determine the true value of casualty losses.

Con.--

° There is a natural tendency to sympathize with individuals incurring medical expenses and as a result there will be many who object to reducing this deduction.

° Any reduction in the medical expense deduction could be preserved for a later time when national health insurance is provided.

HEW Comment.--HEW believes any change in the medical expense deduction should be postponed and used as a means of offsetting a part of the cost of a national health insurance program when it is presented.

Treasury Comment.--Treasury believes a medical expense deduction, even for extraordinary medical expenses, may not be needed when a national health insurance program is provided.

Treasury Recommendation.--Treasury recommends that medical and casualty loss deductions should be combined in a single extraordinary expense deduction and allowed only to the extent the expenses exceed 10 percent of adjusted gross income.

Stu?

Agree ____________

Disagree ____________

Want to Discuss Further ____________

(3) Personal Interest

Present Law.--Nonbusiness investment interest is generally deductible only to the extent of investment income plus $10,000. Excess deductions may be carried over and taken as deductions in any subsequent years. Personal interest on loans for consumption, such as home mortgage and consumer loan interest, is deductible without limitation.

Proposal.--A separate limitation of $10,000 would be imposed on personal interest, such as that on mortgage and consumer loans. Any excess deduction could be carried over and taken in subsequent years subject to the same limitation.

A possible alternative would be to include personal interest (including mortgage interest) in the existing limitation on investment interest (*i.e.*, it along with investment interest would be subject to a *single* limitation of investment income plus $10,000). (This was the initial Treasury recommendation but is no longer supported for reasons indicated below.)

Revenue Estimate.--It is estimated that this proposal would result in a revenue gain of approximately $14 million a year (the alternative would gain $25 million).

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

- While social views on home ownership make an allowance for mortgage interest desirable, it is difficult to see why interest on mortgages on vacation homes, or on very large or expensive homes, should result in deductions which have the effect of lowering the individual's income tax.

- A taxpayer could, under the proposal outlined above, deduct interest at a 9-percent interest rate on a mortgage of $110,000 without limitation. This, in most cases, would cover homes with values of up to $150,000. Excess deductions could be carried over to subsequent years.

- If a separate deduction limitation is not maintained for mortgage and consumer interest (and instead these types of interest are added to the existing investment interest limitation) the political charge will be made that taxpayers with mortgage interest of up to $10,000 are being denied a deduction for their mortgage interest because they also have investment interest. (This view was expressed by Ways and Means Committee members.)

- To deny consumer interest (apart from a mortgage on a home) entirely as proposed by some will hurt many itemizers who for the most part are middle-income taxpayers.

Con.--

- Maintaining a separate mortgage interest limitation (i.e., separate from the investment limitation) will be viewed as overly generous since mortgage debt can be used to carry an investment. On this basis it will be said that investment interest can (if mortgage debt is used) equal investment income plus $20,000.

- Some believe that there should be no limitation on the deduction for interest on the grounds that debt (together with the deduction of the interest on it) represents the principal way today that it is possible for a person starting without wealth to become well-to-do.

- Some believe that a deduction for consumer interest (other than interest on a mortgage on a home) should be denied in its entirety.

HUD Comment.--The proposed ceiling on the deductibility of home mortgage interest, coupled with the treatment of gain on the sale of a residence (discussed in Option Paper No. III), will have an adverse impact on the owner-occupants of houses with a value in excess of $125,000. However, owners of these houses spend a relatively low percentage of their income on housing needs, and are viewed as being outside the area of special concern of HUD.

Domestic Policy Staff Comment.--The Policy staff favors the single $10,000 interest limitation for personal (including mortgage and consumer interest) and investment interest.

Treasury and CEA Comment.--Treasury and CEA believe there would be a difficult political problem if personal and investment interest were combined in the existing $10,000 category; the charge would be made that in some cases all mortgage interest is being denied. Including mortgage interest in the existing limitation for investment interest is believed by members of the Ways and Means Committee to be impossible to enact.

Treasury Recommendation.--Personal interest (including that from mortgages and consumer loans) should be deductible up to a maximum of $10,000 (with a carryover of unused deductions). This would be entirely separate from the limitation under present law for investment interest.

Limits now?

Want separate limitation on personal interest deduction __________

Want combined limitation on personal and investment interest deduction __________

Want to discuss further __________

(4) Political Contributions Deduction

Present Law.--Political contributions are deductible as an itemized deduction up to $200 on a joint return. Alternatively, a taxpayer may take a credit against tax for his contribution up to a maximum credit of $50 on a joint return.

Proposal.--The deduction for political contributions would be repealed but the credit retained.

Revenue Estimate.--The revenue estimate of the change would result in an increase of less than $5 million.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

- A survey has shown that neither the deduction nor credit has induced any significant amount of additional political contributions.

- The deduction is especially undesirable since it provides an extra large windfall to high-bracket contributors.

- The mutually exclusive alternatives of deductions or credits are confusingly complex.

Con.--

- Those in higher income classes may believe the credit is of relatively little value to them and therefore be disinclined to make political contributions.

- Public financing of Congressional campaigns proved to be a controversial issue in the Senate this year. The change proposed here could be viewed as raising a part of this issue again.

Other Agency Comment.--No agency has commented adversely on this proposal.

Treasury Recommendation.--The deduction for political contributions should be repealed but the credit retained.

Agree ✓

Disagree ______

Want to discuss further ______

(5) Charitable Contributions

Present Law.--Charitable contributions are deductible up to 50 percent of adjusted gross income (30 percent in the case of appreciated property) with a 5-year carryover of excess contributions. The limit is 20 percent in the case of contributions to private foundations. The full fair market value of appreciated stock and real estate is deductible even though the appreciation is not taxed (if the property is given to a private foundation the advantage of giving appreciated property is removed).

Proposal.--The Treasury is opposed to any of the changes discussed below but a number of proposals have been made by others with respect to charitable contributions. (The proposed treatment of appreciated property, which relates to the change in the tax treatment of capital gains, is discussed further in Option Paper No. III.)

Proposals most often made in the case of the charitable contribution deduction include the following:

(1) Replace the charitable contribution deduction with a 30 percent credit available to nonitemizers as well as itemizers.

(2) Permit the deduction, for those who itemize and those who do not, of any charitable donation in excess of a floor--one example of such a floor is 3 percent of adjusted gross income or $5,000, whichever is less.

Discussion of the Issues.--The primary reasons for and against the two alternatives are:

Pro.--

- The credit proposal probably improves equity in the sense that under it charitable giving for persons at different income levels will involve essentially the same cost--that is 70 percent of the amount given.

- One study suggests that the 30 percent credit will increase total charitable contributions by 8 or 9 percent although contributions to educational institutions will decline by 3 percent.

- The 3 percent floor (or $5,000 floor if smaller) simplifies computations under existing law in that itemizers whose charitable contributions are relatively small are not allowed deductions.

- The 3 percent floor also is favored on the grounds that it treats itemizers and nonitemizers on a more uniform basis than does present law.

Con.--

- Changes proposed elsewhere in the option papers may decrease charitable giving. Reducing top rates to 50 percent probably reduces incentives to give to educational institutions, hospitals, etc.

Some believe reducing some itemized deductions and shifting taxpayers to standard deductions may decrease giving to religious institutions, United Way, etc., where contributions tend to be small. (However, prior experience suggests this latter point is not true.)

- Reducing tax advantages provided by present law in the case of private schools, colleges, hospitals, and other similar institutions will decrease the ability of these institutions to obtain funds during a period when they are having special difficulties in financing their programs (currently they tend to have inadequate operational income, reduced endowment income, and limitations on the ability to increase tuition, service charges, etc.). As a result, the private institutions can be expected to very strongly oppose any of the possible changes outlined above and this could well create a significant danger for the entire tax reform program.

- Moving the top marginal rate down from 70 percent to 50 percent as provided by the Treasury proposal in itself would substantially reduce the advantage of charitable giving for higher income taxpayers. The 30 percent credit would mean that those in the upper tax brackets would find the tax benefits of charitable contributions further reduced. Charities will have difficulties in opposing rate reductions but can be expected to very strongly oppose credits which reduce the advantage of charitable giving.

- The mix of charitable giving under this proposal would change appreciably. To the extent charitable contributions of those in the lower tax brackets are increased this would increase giving to churches, boy scouts, girl scouts, United Way, etc. On the other hand it is likely that this change in charitable contribution mix would decrease significantly contributions to higher education, museums, operas, etc.

- Religious organizations are strongly opposed to substituting a credit for the deduction on the grounds that the credit is vulnerable on the constitutional grounds requiring the separation of church with state.

- It would be necessary to provide some kind of a floor under the credit proposal. Without a floor the Internal Revenue Service would have to review charitable contribution deductions of very small amounts on four times as many returns. Taxpayers assume that it is appropriate to list unrecorded charitable contributions of some minimum amount, without questions being raised, and Internal Revenue personnel in practice accept these deductions without verification. As a result, with the credit charitable contributions would be claimed on virtually all tax returns. Not only is there an increase in auditing involved in this, but also the tax return itself would have to provide for an additional credit, on both the short form and long form.

- The 3 percent floor requires more computations on the tax return form for those using the short form as well as the long form.

Other Agency Comment.--No agency has recommended any change in the charitable contribution.

Treasury Recommendation.--The Treasury does not recommend any change in the charitable contribution deduction at this time.

Agree ✓

Disagree ________

Want to discuss further ________

3

THE WHITE HOUSE

WASHINGTON

September 23, 1977

MEMORANDUM FOR: THE PRESIDENT

FROM: STU EIZENSTAT Stu
BOB GINSBURG

SUBJECT: Option Paper No. III: Capital Gains and Losses

1. Areas of Agreement. We support Treasury's recommendations to:

   (a) tax capital gains as ordinary income;

   (b) tax capital gains on transfers at death or by gift;

   (c) provide a special credit for venture capital in small business;

   (d) allow capital losses in full against ordinary income but limit losses from marketable securities to gains from marketable securities plus $10,000 a year;

   (e) leave unchanged the present law treatment which permits an income tax deduction for the full amount of the appreciation on property given to charity; and

   (f) permit the timber industry to expense (as opposed to capitalize as under present law) regeneration and reforestation costs.

   The $10,000 limit on losses from marketable securities is an arbitrary number. In its first presentation to you this spring, Treasury recommended a lower limit of $8,000 (the lower limit would save us about $100 million a year in revenue). In his tax reform program, Senator Kennedy proposed a $9,000 limit.

   The venture capital rule and the special provision for the timber industry are recommended not on the merits but as an attempt to mollify some of the strong objections which will be taken to our capital gains proposals (the most controversial aspect of our tax reform program). The venture capital rule in particular will to some extent allay the criticism that these proposals will discourage the formation of new businesses.

2. Inflation indexing for capital gains. We strongly oppose Treasury's recommendation that an inflation adjustment be provided for determining capital gains on property held for more than 10 years:

-- An inflation adjustment for the holders of securities would provide no protection for the small savers who earn interest on their bank accounts and are fully taxed on the interest and the wage earners who get cost of living increases and are fully taxed on those increases. We do not see why a Democratic Administration should propose inflation indexing for the holders of capital assets but not for the vast majority of other taxpayers who are even more vulnerable to inflation.

-- Once we introduce indexing into the tax system, we may not be able to draw a line, and indexing of the tax system could lead to major difficulties in ever trying to get inflation under control.

-- Inflation indexing is contrary to our simplification goal, which is a major factor behind the desire to eliminate the capital gains preference in the first place.

-- As a matter of economics, accelerated depreciation and the ability to defer tax on capital gains until they are realized tend to offset the impact of inflation on capital assets.

-- Inflation indexing would involve a lock-in effect which would decrease the mobility of capital.

-- There is a general consensus among the tax experts at Treasury (as witnessed by the pros and cons set out in the option paper) that indexing is a very inadvisable proposition.

Tax Reform Option Paper No. III

Capital Gains and Losses

Five tax reform proposals affecting capital gains and losses are set out below: (1) capital gains realized during life, (2) capital losses realized during life, (3) gains and losses on transfers at death or by gift, (4) tax treatment of capital gains on transfers to charities, and (5) expensing of regeneration and reforestation costs for timber.

(1) Capital Gains During Life

Present Law.--One half of a long-term capital gain is included in an individual's tax base (thus the effective rate of tax ranges from 7 percent to 35 percent). A special limit provides that $50,000 of these gains each year are not to be taxed at over 25 percent. Long-term capital gains of corporations are taxed at 30 percent. The untaxed portion of capital gains is included in the base of the minimum tax (which brings the maximum rate up to about 40 percent for individuals). Capital gains treatment applies not only to securities, real estate, etc., but also to such transactions as the sale of timber, iron ore and coal royalties, and certain royalty income from patents.

Currently, gain on the sale of a residence need not be included in income if the sale proceeds are reinvested in another home within 18 months (24 months where the house is being built). In addition, gain attributable to the first $35,000 of a home sale can be excluded by an individual who is at least 65, with the exclusion reduced proportionately for sale prices over $35,000.

Proposal.--Capital gains realized during life would be taxed as ordinary income. However, gain attributable to the sale of a principal residence with a value of up to $75,000 would be exempt from tax regardless of the seller's age, with the exemption reduced proportionately for sale prices over $75,000. As under current law, gain on a residence would also be excluded if the sale proceeds are reinvested in another home within 18 months (or in some cases in 24 months).

Basis Adjustment.--In addition, in view of the extensive interest in the adverse effect of inflation on capital gains, it would appear desirable to increase the cost or basis of real property or securities for purposes of determining gain by the rise in the consumer price index but only to the extent the property is held for more than 10 years.

Phase in of Change.--The new treatment for capital gains would be phased in over a 3-year period.

Venture Capital Rule.--Gain on the sale of venture capital stock held for 10 years or more (or transferred at death) would be taxed at a net rate which approximates the combined maximum regular rate on capital gains and the minimum tax rate under current law. This would be accomplished by a credit against the tax equal to 10 percent of the gain. This brings the proposed maximum rate down from 50 percent to 40 percent (which is the equivalent of the percent maximum capital gains rate of 35 plus the minimum tax). This treatment would apply to the first $1 million of stock issued by newly formed unaffiliated corporations engaged in manufacturing, research, or extraction. The stock would be only that issued in the first 5 years of the corporation's existence and at a time when the stock was not publicly traded.

Revenue Estimate.--Taxing capital gains as ordinary income would increase tax revenues from individuals by $3.7 billion and from corporations by $700 million.

Discussion of the Issues.--The primary reasons for and against this proposal in general are:

Full Taxation of Capital Gains

Pro--

- Capital gain income in most respects is the same as wages or interest and therefore from the standpoint of equity should be treated the same.

- The definition of capital gains under current law is a major source of complexity in the Code and a constant cause of litigation.

- Another benefit from deriving income from capital gains is that the taxpayer can defer realization and thus postpone the tax. This may cause a bunching of income realized in 1 year which is attributable to a long period of time, but the impact of bunching is mitigated by the current 5-year averaging rules for both ordinary income and capital gains.

° The major part of the revenue for scaling down the top bracket tax rates is dependent on the elimination of the preference for capital gains.

° Treating capital gains as ordinary income would permit capital gains to be removed from the minimum tax and from the preference offset of the maximum tax on earned income. This, plus the general rate cuts, mitigates the tax increase on capital gains.

Con--

° To many (e.g., see press comments of Arthur Burns) taxing capital gains as ordinary income will be viewed as a step against capital formation. (To overcome this it will be desirable to stress that when ordinary income rates are reduced to a top of 50 percent, this largely offsets any otherwise adverse effect on capital gains. In addition, capital formation is aided by the business tax changes. Under the proposed tax reform program there is a substantial reduction in the total tax on corporate source income.)

° The full taxation of capital gains would to some extent discourage the realization of gains. (This is mitigated by the reduction in marginal tax rates and by the proposal to tax gains at the time of death.)

° This proposal will substantially increase the tax on timber income and the timber industry will assert that the long time required to raise timber justifies a lower rate of tax. (Expensing reforestation costs offsets part of this change in tax. Other special adjustments ultimately may be required here.)

10% credit
on 1st $5000 profit

Indexing

Pro--

° There is a widely held belief (especially widely held at the Congressional level) that to tax "capital gains" as ordinary income without making an inflation adjustment has the effect of taxing as income something which is only nominal income and instead merely reflects a general price rise.

Con--

° In the case of depreciable assets, the benefit of accelerated depreciation has approximately offset the detriment of price rises except during the period of double digit inflation.

° Deferral of the taxation of capital gains until they are realized tends to offset the inflationary impact.

° Recipients of all property income such as savings account depositors are also affected by inflation, but they would not be helped by an inflation adjustment for capital gains.

° Equity would seem to require an offset to any indexing for inflation to the extent the purchase of the property is financed with debt, since the value of the property representing debt is paid off in cheap dollars. Such an adjustment would be so complicated that it probably would have to be foregone.

° An adjustment for inflation would add substantial complexity to the tax laws since if would be necessary to distinguish between real property and security gains, which would be eligible for the inflation adjustment, and other property which is not eligible. This would also require provisions to prevent taxpayers from disguising other property as securities (for example, by incorporating their bank accounts or their jewelry) and to determine the acquisition date when improvements were made to property or additional contributions were made to a corporation.

° Adjusting capital gains for inflation may lead to indexing in other areas of tax law.

Venture Capital

Pro--

- ° Allowing this special treatment will defuse much of the objection as to injury to venture capital from repeal of removing capital gains treatment.
- ° Although investors in small corporations already receive ordinary loss treatment to some extent under present law, the allowance of ordinary loss treatment is not a compensating benefit for full taxation of gain.
- ° A credit is more equitable than the current exclusion for one-half of capital gain. A 10-percent credit reduces the tax by 10 percent for all taxpayers whether in high or low brackets.

Con--

- ° Allowing another exception to full taxation of gain will further open the door to other claims for special treatment and could lead to some of the complexities that now plague the definition of capital gain.

Department of Agriculture Comment.--Agriculture has indicated that eliminating the capital gains exclusion will have an impact in forestry, land sales and farm businesses such as breeding herds, orchards, and vineyards. However, no recommendation for change was made. The overall increase of tax liabilities to the farming sector resulting from the elimination of capital gains will be less than $0.5 billion a year after allowance for the overall tax reduction. Elimination of special capital gains treatment could reduce the attractiveness of farm land as speculation but at the same time enhance a "lock-in" effect on the ownership of land.

HUD Comments.--HUD supports the proposal to eliminate the preferential tax treatment of capital gains. HUD notes that, although this reform reduces the rate of return on real estate investment, it similarly affects the rate of return on all other investment.

Council of Economic Advisers' Comments.--The CEA recommends that indexing of long term capital gains be eliminated from the proposal. They support the arguments previously listed in opposition to indexation, i.e., inequitable, favorable treatment relative to other assets such as savings accounts, and deferral and depreciation provisions currently offsetting the inflation burden. The CEA further notes that the provision of such a benefit only after an asset has been held for ten years would reduce the mobility of capital. Once an asset had been held ten years the effective tax rate on future appreciation would be sharply lower than the tax on alternative new investments. Finally, CEA believes it is important to resist indexing of the tax system here as elsewhere.

Domestic Policy Staff.--The Policy staff joins the CEA in opposing the indexing of basis for assets held over 10 years.

Treasury Comment.--Treasury recognizes the inequities involved in indexing capital gains and not other aspects of the tax law. (Most of the points made above appear in the prior Pro and Con discussion.) Nevertheless, the proposal is made because it is thought necessary in order to obtain the approval of the taxation of capital gains as ordinary income. There is a feeling that inflation is a more important factor in capital gains taxation than is true in other aspects of the tax law. While there is some "lock-in" effect as a result of indexing property held more than 10 years, in view of the fact that there is no indexing in any case for the first 10 years, this tends to have an appreciable effect only after property is held for 15 to 20 years. Most property would not fall in this category.

Treasury Recommendations.--Capital gains should be taxed in full when realized.

Agree ______

Disagree ______

Want to discuss further ______

An adjustment should be made for inflation to the extent real property or securities are held over 10 years.

Agree ______

Disagree ______

Want to discuss further ______

A 10-percent credit against tax liability should be allowed with respect to gain on "venture capital" investments.

Pechman ?

Agree ______

Disagree ______

Want to discuss further ______

(2) Capital Losses

Present Law.--Capital losses may offset capital gains in full. In the case of individuals, one-half of net long-term capital losses (and all net short-term losses) may offset ordinary income up to $3,000 in 1978 and later years. Any loss still remaining may be carried forward for an unlimited period of years. In the case of corporations, capital losses can be offset only against capital gains but any remaining loss may be carried back 3 years or forward 5 years and applied against capital gains in those years.

Proposal.--Capital losses would be allowed in full against ordinary income except that the offset of losses from marketable securities would be limited to gains from marketable securities plus $10,000 a year. Any remaining loss would be carried forward for an unlimited period of years. However, losses on marketable securities would be allowed in full in the current year except to the extent of unrealized gain in securities currently held.

In the case of corporations the loss would be allowed in full except that, in the case of marketable securities, the loss would be limited to gain on marketable securities but with an unlimited loss carryforward.

Revenue Estimate.--The revenue cost of this proposal is incorporated in the revenue gain from taxing capital gains in full. If stated separately, this would cost $2 billion.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro--

- Maximum simplification would be achieved if capital losses were allowed in full. However, unless some limit is placed on the deductibility of losses, taxpayers would have an incentive to realize losses and to defer gains. This is particularly true in the case of marketable securities. Providing a limitation on the deductibility of losses only in case of marketable securities will minimize the whipsaw effect from realizing losses and deferring gains, while at the same time achieving most of the simplification that could be achieved if losses were allowed in full.

Con--

- ° If gains are going to be taxed in full many will argue that losses should be permitted in full. This is particularly true in the case where a taxpayer has no unrealized capital gains. (Allowing losses except to the extent of unrealized gains in present holdings should overcome this objection.)

- ° The additional allowances of losses in some cases above $10,000 will add to the complexity of this provision. (This, however, will apply to a small group.)

HUD Comment.--HUD believes that the proposed treatment of capital losses will, to some extent, counterbalance the proposals relating to depreciation (discussed in Option Paper IV). HUD notes, however, that the restriction on depreciation combined with the allowance of losses might have unfortunate implications for housing. It fears that owners of multi-family rental properties might prematurely dispose of such property in order to recognize economic losses not allowable under the proposed new system for depreciation.

Treasury Comment.--As long as allowable tax depreciation is at least as rapid as the decline in economic value of buildings there should be no tax incentive to sell properties and realize losses.

Treasury Recommendation.--Treasury recommends that capital losses be allowed in full except for the limitations described above in the case of marketable securities.

5the?

Agree ______

Disagree ______

Want to discuss further ______

(3) Gains and Losses on Transfers at Death or by Gift

Present Law.--Presently there is no tax on the appreciation in the value of property transferred at death. Instead, under the law enacted in 1976, the cost or other basis of the property in the hands of the decedent carries over and is the basis of the property in the hands of the heir (increased by appreciation attributable to periods before 1977). Basis of property also carries over in the case of gifts. (This basis is increased by the amount of the gift or estate tax paid on the appreciation.)

Proposal.--The appreciation (occurring after 1976) in property transferred at death generally would be taxed at that time, with long-term averaging. There would be a general minimum exemption from this tax of $175,000 so that all estates not required to file estate tax returns would be totally exempt. The $175,000 minimum exemption would be satisfied first with cash, life insurance and similar assets. Certain assets would be exempt even if not covered by the $175,000 exemption: life insurance, $10,000 of personal and household effects, the value of a principal residence of $75,000 (with a proportional exemption for residences worth over $75,000), charitable transfers, marital deduction transfers, and transfers of farms, and closely held business interests. (However, carryover basis rules would apply in the case of the martial deduction and the transfer of farms and closely held businesses.) All losses would be recognized.

In the case of property transferred by gift (other than to charity), the appreciation would also be taxed.

Except for the special carryover basis exemption, basis for recipients would be stepped up to fair market value.

An alternative would tax at death all appreciation, including that attributable to periods before 1977.

Revenue Estimate.--Taxing capital gains and losses on transfers at death or by gift would increase tax revenues after a long period of years by $1.6 billion.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro--

- Taxing gains on transfers at death or by gift would improve equity between taxpayers who have realized gains during life and those who have not.

- Taxing gains at death would reduce the incentive for taxpayers to hold assets and defer taxation of the gains indefinitely--in other words it will improve liquidity. It is especially important in view of the recommendation made earlier that capital gains during lifetime be taxed as ordinary income that we do as much as possible to "unlock" the sale of capital gain property.

- Taxing gains at death would be simpler than the carryover basis rules provided in the 1976 Tax Act.

Con--

- Congress provided a carryover basis rule in 1976. A recommendation to tax gains at death could meet strong opposition. Ranking minority member Conable from the Ways and Means Committee would like to reverse the carryover basis rule. Chairman Ullman fears that if we try to tax gains at death we might not only lose that but might also lose the carryover basis rule of present law as well.

- Carryover basis would in any event be needed for transfers to a spouse and for transfers of a closely held business or a farm to family members. Thus, the complexities of this rule cannot be avoided.

- Since Congress insisted on eliminating pre-1977 appreciation from last year's carryover basis rule, it unquestionably would regard it as unfair to tax pre-1977 appreciation under the realization at death rule. Most persons with capital gains would regard it as unfair retroactivity, a change in the rules of the game after the fact, and its inclusion might tarnish the basic proposal as unreasonable.

Agriculture Department Comment.--If capital gains at death are taxed and an exception is provided for farms passing to children, protection is needed to prevent non-farmers from buying farms in order to avoid tax on gains at death.

Treasury and CEA Recommendation.--Although concerned as to the views of the Ways and Means Committe with respect to this proposal, we favor taxing gains on transfers at death or by gift as outlined above.

Agree ______

Disagree ______

Want to discuss further ______

(4) Taxation of Capital Gain Transferred to Charity

Present Law.--Gifts to charity, including appreciated property, are usually deductible for income tax purposes to the extent of the fair market value of the property. However, in the case of appreciated property, gain is effectively taxed if the transfer is to a private non-operating foundation. In the case of gifts to other charities although appreciation is not taxed, the deduction in these cases is limited to 30 percent of AGI.

Proposal.--In the case of gifts or bequests to charity (other than nonoperating private foundations) of marketable securities and real estate, the income tax deduction for the contribution would not be reduced by any part of the appreciation. (This is merely maintaining the present law rule for these assets.) For contributions of works of art by the artist (today the deduction is limited to the cost of materials) the deduction would be liberalized by also allowing a deduction for 50 percent of the appreciation. In the case of other property, the deduction would be limited to basis.

There would be no income taxation on the appreciation of bequests given to charity.

Revenue Estimate.--The revenue loss from this provision is less than $5 million and is included in the prior section.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro--

- Not reducing charitable deductions by the unrealized appreciation in the value of the gift maintains the present law treatment for making gifts. This maintains or expands somewhat the current advantage for the more important forms of charitable gifts. For paintings and sculpture donated by artists for use of the tax exempt organization, the charitable deduction will increase over current law, which limits the deduction to basis.

- Educational institutions place a high value on property gifts. They have been referred to as "seed money" for general fund raising campaigns. The American Counsel on Education reports in a 1973-1974 study that approximately 40 percent of total gifts by individuals were property gifts. Unless the present treatment is maintained (as the proposal does), educational institutions will strongly oppose the taxation of capital gains as ordinary income.

- The effect of taxing appreciated property can be seen by comparing what an individual has left if he sells property vs. giving it to charity. Assume property has a fair market value of $1,000 and that $800 of it is appreciation in value which has not been taxed. Under present law if the property is sold at top capital gains rates plus the minimum tax (about 40 percent), the tax is $320, leaving $680. If the property is given to charity the tax saving from the deduction (top rate 70 percent) is $700, or $20 better than if sold and taxed at top rates. Under the proposals if the property is sold at top ordinary income tax rates (50 percent) the tax is $400, leaving $600. If the property is given to charity the tax savings from the deduction (top rate 50 percent) is $500, which is $100 less than the after-tax proceeds from a sale.

Con--

- If capital gains are taxed in full and no change is made in the treatment of appreciation on charitable gifts, the tax expenditure from appreciation on charitable gifts increase somewhat over present law.

Treasury Recommendation.--In the case of transfers to charity of marketable securities, real estate, and certain tangible personal property the income tax deduction for contributions would continue to be available for the full amount of appreciation. In the case of other property the deduction would be limited to basis.

Agree __________

Disagree __________

Want to discuss further __________

(5) Expensing of Regeneration and Reforestation Costs for the Timber Industry

Present Law.--Income from the sale or cutting of timber is eligible for capital gains treatment, but regeneration and reforestation costs must be capitalized and recovered when the timber is sold.

Proposal.--The timber industry would be permitted to expense regeneration and reforestation costs.

Revenue Estimate.--Expensing would reduce tax revenues by $53 million per year.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro--

- Almost all gains from the sale or cutting of timber receive capital gains treatment. Treating capital gains as ordinary income will have an adverse effect on this industry.
- Expensing of regeneration and reforestation costs will provide a positive incentive for reforestation.
- This expensing compensates the timber industry to some extent for the loss of capital gains treatment.

Con--

- Regeneration and reforestation costs are capital costs. If these costs are expensed, there is a mismatching of income and expense. Accordingly, this provision would be a new tax expenditure.

° It is likely that Congress will want an exception from full taxation of capital gains for the timber industry, and it is unlikely that this expensing will, by itself, be viewed as generous enough.

Other Agency Comment.--No agency made any adverse comment on this proposal.

Treasury Recommendation.--If capital gains are taxed in full, regeneration and reforestation costs should be expensed.

Agree __________

Disagree __________

Want to discuss further __________

4

THE WHITE HOUSE

WASHINGTON

September 23, 1977

MEMORANDUM FOR: THE PRESIDENT

FROM: STU EIZENSTAT Stu
BOB GINSBURG

SUBJECT: Option Paper No. IV: Tax Shelters and Preference Income

1. Areas of Agreement. We support Treasury's recommendations to:

   (a) curtail real estate tax shelters by tightening the rules for depreciation of real estate;

   (b) require corporate farms with gross receipts of more than $1 million to use accrual (as opposed to cash) accounting;

   (c) phase out the percentage depletion for hard minerals over a ten-year period;

   (d) classify the immediate expensing of intangible drilling costs by the oil and gas industry as an item of preference income and include it in the minimum tax for individuals and corporations;

   (e) eliminate the special bad debt deduction for commercial banks, phase the 40% bad debt deduction for savings and loan associations down to 20% over five years, and tax credit unions to the same extent as savings and loan associations; and

   (f) strengthen the minimum tax provisions.

   If you want to take a tougher stand on percentage depletion for hard minerals, we could propose elimination over a five-year instead of a ten-year period. If passed by Congress, the quicker phase-out would pick up an additional $1 billion in revenue between now and 1982. The mineral industries will vigorously oppose elimination even over a ten-year period. We do support the longer phase-out period, however.

The alternative with respect to intangible drilling costs (IDC) is to not only include it in the minimum tax base but also eliminate it over a period of years. IDC is the only remaining major tax preference available to both the major oil companies and the independents. We reluctantly recommend inclusion only in the minimum tax base at this time because of our concern for the adverse effect a stronger proposal might have on the energy legislation.

elim

2. <u>Percentage Depletion for Oil and Gas</u>. Percentage depletion for oil and gas is no longer available to the major companies and is being phased down for the independents from 22% to 15% in 1984. We recommend that beginning in 1984 the remaining 15% depletion allowance be eliminated over a five-year period:

-- Percentage depletion for oil and gas is a highly symbolic tax preference. Its elimination has always been a basic objective of tax reformers.

-- If we leave percentage depletion for oil and gas untouched, our ability to eliminate percentage depletion for hard minerals may be adversely affected by our inconsistent position.

-- Percentage depletion for the independents remains as one of our most unwarranted tax preferences -- it adds little to production and benefits one of the wealthiest groups in the country.

We would note, however, that the tax reform merits of this proposal should be balanced against the potentially adverse effect it might have on our energy legislation, which is already criticized (unfairly) for providing inadequate incentives for exploration.

Tax Reform Option Paper No. IV

Tax Shelters and Preference Income

This memo sets out specific tax reform proposals concerning tax shelter investments and preference income. Specifically, the proposals relate to real estate, agriculture, mineral industries, financial institutions, the minimum tax and related items.

(1) Real Estate.--Depreciation on Buildings

Present Law.--Taxpayers are allowed a deduction for depreciation based on the useful life of the property. The life depends upon the "facts and circumstances" in the particular case. For real estate the IRS uses guideline lives, set out in 1962, which range from about 40 years for apartments and hotels to 60 years for warehouses. However, in actual practice, taxpayers are using considerably shorter useful lives. The most favorable methods of depreciation allowed by the law range from 200 percent declining balance depreciation for new residential properties down to straight line depreciation for used nonresidential properties.*/

Proposal.--As an interim rule, taxpayers would be required to base their depreciation for buildings generally on straight-line depreciation--but 150 percent declining balance depreciation for new multi-family housing--and the present average tax lives claimed by taxpayers (compiled by the Treasury) for different classes of property. However, beginning in 1981 they could not write down the property below the remaining mortgage; that is depreciation would be limited to equity. The Treasury would begin an immediate study of how much in fact buildings depreciate in value over each 10- (or 20-) year period, based upon prices (after removing inflation) at which different classes of buildings sell. At the end of a 3-year period, these studies would be published, setting out the decline in value of a building over each 10- (or possibly 20-) year period. Thereafter, taxpayers could elect either to continue use of the interim

*/ For new residential rental properties, 200 percent declining balance depreciation is available, for new nonresidential properties, 150 percent declining balance depreciation, for used residential rental property, 125 percent declining balance depreciation, and for used nonresidential properties, straight-line depreciation.

rule or to depreciate their buildings by using the straight-line (or 150 percent declining balance for multi-family housing) method with total deductions for depreciation limited to the established decline in value in the applicable categories over each 10- (or 20-) year period that the building is in use. If the latter method were used, depreciation would not be limited to equity of the taxpayer in the property. Present rules would be retained for low-income housing but only for the period until 1982.

Revenue Estimate.--The proposed tightening of real estate depreciation would increase revenues by $400 million from individuals and $300 million from corporations.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

- Existing methods of depreciation (even ignoring the effect of inflation) are exceedingly uneven in application and clearly overstate the decline in value. This enables profitable real estate investments to be reported as tax losses.

- Real estate shelters provide a principal avenue for tax avoidance by high-income individuals. They are highly visible, and a failure to deal with them would be severely criticized.

- The 1976 Tax Reform Act generally applied an "at risk" rule to different forms of tax shelters (similar, but not identical, to the equity limitation set out above) but no such rule was applied in the case of real estate. Instead, limitations were imposed only on the extent to which construction period interest and taxes could be expensed.

Con.--

- Some fear that any cut back in accelerated depreciation for housing will reduce capital investment in housing. (In reality this depends more than anything else on the interest rate at which funds can be borrowed for housing. The changes being proposed would have about the same impact on real estate as a 1 percentage point increase in mortgage interest rates.)

- The investment credit helps other forms of investment--primarily the purchase of equipment under present law (although recommendations in Option Paper No. IX extend this to industrial structures). Some believe that this requires special subsidies for real estate to prevent a diversion of investment away from housing.

HUD Comments.--HUD believes that the proposed rules for real estate depreciation would substantially reduce the rate of return on housing tax shelters--possibly from 13.3 percent to 10.4 percent. (Note: These comments were about an earlier set of proposals--see Treasury Comment.) It suggested that nonsubsidized multi-family housing could continue to compete in the equity markets for investment capital if the projected decline in the rate of return from housing investment reflected a general increase in the level of taxation of all capital. HUD fears that equity capital might be diverted from housing to other industries on account of such tax provisions as: the continued deductibility of intangible drilling expenses (subject only to the minimum tax), the allowance of an investment credit for industrial structures, a reduction in corporate tax rates, and partial integration.

HUD is convinced that construction of subsidized housing would virtually cease if the present provisions for accelerated depreciation were eliminated, or even reduced. Therefore, it requests that subsidized housing be excluded from the proposed limitations on depreciation. (Note: They are excluded through 1981.)

CEA Comment.--CEA feels that it is important not to discriminate against industrial, utility, and other productive investments in favor of apartments. At least in part because of the favorable tax treatment to real estate, there was substantial overbuilding and speculation in the late 1960's and early 1970's. Indeed, there continues to be an oversupply of such buildings in many areas of the country.

Similarly, CEA believes that the cost effectiveness of using tax policy to subsidize "low income housing" is very questionable. In terms of budget dollars, this tax subsidy probably benefits high income builders more than low income occupants. Several studies indicate that for every dollar of subsidy to low income housing, less than

50 cents shows up in increased real income of low income families. Channeling these funds into rent subsidies--or even better welfare reform--is a much more cost effective way of alleviating poverty. In addition, it is much better budgetary practice to put these subsidies into appropriations where they are subject to the usual scrutiny, rather than into the tax law.

For these reasons, CEA feels that there should be no exceptions to the proposed straight line depreciation rules for buildings. In this respect it supports earlier Treasury proposals over the current one.

Treasury Comment.--Most of the points to which HUD makes comparisons with respect to housing are designed to improve the general rate of return for capital. The rates of return on most tax shelter investments were tightened substantially more last year than was true in the case of housing shelters. Nevertheless, Treasury after considering HUD recommendations changed the proposal in two respects: (1) in the case of multi-family housing the method of depreciation would be 150 percent declining balance, instead of straight-line, and (2) the rule limiting depreciation to equity would be postponed for 3 years until the alternative system is available. This should raise the rate of return in the case sited by HUD from 10.4 percent to about 12.0 percent.

Treasury Recommendation.--Limit the depreciation on buildings (other than low-income housing) as outlined above.

Agree ____________

Disagree ____________

Want to discuss further ____________

(2) Agricultural Accounting for Corporations

Present Law.--Generally, it has been possible for a taxpayer engaged in farming activities to report the results of those activities for tax purposes on the cash method of accounting. Apart from farm operations, the tax rules generally require the use of the accrual method of accounting in the case of taxpayers engaged in the business of selling products. These other taxpayers report their income on the accrual method of accounting and accumulate their production costs in inventory until the product is sold.

The 1976 Tax Reform Act requires farming corporations other than "family-owned" corporations, subchapter S corporations (those taxed essentially like partnerships), and corporations with gross receipts of less than $1 million to use the accrual method of accounting for farm operations and to capitalize their pre-production period expenses of growing or raising crops or animals. A "family-owned" corporation which is not required to use the accrual method of accounting under the 1976 Act refers to a corporation in which at least 50 percent of the stock is owned by members of the same family.

Proposal.--All corporate farms (except those taxed as partnerships) with gross receipts of more than $1 million would be required to use accrual accounting. This means that the large corporate family farms would be required to account for inventories and amortize capital costs. In addition, noncorporate farm syndicates (those offered for sale through registered offerings or where more than 35 percent of the losses are allocated to outside investors) would also be required to use accrual accounting, even if their gross receipts are less than $1 million.

Revenue Estimate.--Repealing the corporate family farm exception from accrual accounting would increase revenues by $30 million.

Discussion of the Issues.--The primary reasons for and against this proposal are:

Pro.--

° This would deal with the principal remaining tax shelters where losses from farm corporations or syndicates are, for tax purposes, used to offset income derived from other sources.

- Large enterprises can be expected to compute their income correctly for tax purposes. In most cases, they already do it for financial purposes. A rule intended for the administrative convenience of small farmers should be limited to those who may not have the resources to use more sophisticated accounting.

- Those interested in farming only because of the tax losses involved should not artificially expand farming operations and in this way make it difficult for the actual farmer to make a profit.

Con.--

- Especially in the case of corporate chicken farming, cash accounting has been used to defer the tax on sizeable amounts of income. In addition to outright opposition to this proposal, corporate chicken farmers will seek a rule permitting them to continue to defer taxes attributable to the past.

Department of Agriculture Comments.--This provision will generally affect only a few large farms; they are generally concentrated in the poultry industry in a few western States. The egg industry has sought Federal legislation requiring accrual accounting for their industry. The Department of Agriculture is on record as favoring the gradual elimination of the right of commercial farmers to use cash accounting for tax purposes.

Treasury Recommendation.--All farm corporations (except those taxed like partnerships and those with less than $1 million of gross receipts) and farm syndicates would be required to use accrual accounting methods.

Agree __________

Disagree __________

Want to discuss further __________

(3) Mineral Industries

Present Law.--Taxpayers engaged in drilling for oil and gas may deduct, instead of capitalize, much of the cost (intangible drilling costs) incurred in developing an oil or gas well whether or not the well is successful. Expenditures for exploration and development in other mining activities, subject to limitations, also may be expensed.

In place of writing off the cost of mineral properties over the expected lifetime of the mine or well (cost depletion), taxpayers can deduct various specified percentages of the gross income from the property (percentage depletion). There are at least 125 different percentage depletion categories with rates ranging from 22 percent for such items as sulphur and uranium to 5 percent for gravel, sand, and peat. In 1975, in the case of oil and gas, percentage depletion was denied to the majors; and for the "independents," up to 1984 depletion is to be phased down from 22 percent to 15 percent and allowed only with respect to the first 1,000 barrels of oil production per day.

Proposal.--Percentage depletion for hard minerals would be phased out over a 10-year period.

Alternative: It would also be possible (not recommended by Treasury) to phase out percentage depletion for hard minerals over 5 years.

Why? Proposal.--Percentage depletion allowed for oil and gas would not be changed.

Alternative: It would also be possible (not recommended by Treasury) to phase out percentage depletion for oil and gas for the independent companies in the 5-year period beginning in 1985.

Proposal.--Intangible drilling costs for both individuals and corporations would be classified as a preference for purposes of the minimum tax. Presently they are so classified only for individuals to the extent these costs exceed the income derived from oil related properties. (This minimum tax proposal is discussed below.)

Revenue Estimate.--Repealing percentage depletion for hard minerals will increase revenues by $700 million when fully phased in. There would be no revenue pick up until after 1984 if oil and gas percentage depletion were phased out. Eventually, the revenue gain would be $600 million.

Discussion of the Issues.--The primary reasons for and against this proposal are:

General

Pro.--

- In view of the increasing need to conserve minerals, an incentive to encourage increased production of hard minerals, and consequently to lower their prices, does not appear to be desirable.
- Percentage depletion has been eliminated for the major oil companies and is, over the years through 1984, being reduced for the independents. On the same basis, it is difficult to see why percentage depletion for hard minerals should not also be reduced or eliminated.

Con.--

- In practice it will be difficult to get Congress to eliminate percentage depletion for hard minerals. Congress may agree to substantially reduce it but will probably refuse to eliminate it.
- Congress would be especially reluctant to phase out percentage depletion for hard minerals over as short a period as 5 years. The mining of hard minerals is spread over many States.

Percentage Depletion for Oil and Gas

Pro.--

- There will be public criticism if percentage depletion is not eliminated for gas and oil (as set out in the alternative).
- Even if ultimately this provision is lost, it could prove to be a useful bargaining chip with Congress.
- In as much as percentage depletion is eliminated for all other minerals it should be eliminated for oil and gas as well.

Con.--

- Elimination of percentage depletion for oil and gas would be difficult to do in view of energy needs.

° Percentage depletion for oil and gas is being phased down under present law up to 1984, and is not now available to the major companies. Thus, practically there is no need that action be taken on this for several years.

Intangible Expenses

Pro.--

° The concept of tax reform requires the imposition of a minimum tax in these cases if a serious tax shelter is to be avoided for the independent producers.

° Discrimination between corporations and unincorporated enterprises engaged in oil and gas operations can be removed by imposing the minimum tax in the case of both individuals and corporations with respect to intangible drilling expenses.

Con.--

° Subjecting the expensing of intangible drilling expenses to the minimum tax appears inconsistent with the purpose of the energy bill. (This might be reconciled with tax reform by postponing this change for 2 years.)

Exploration only ?

° Eliminating the expensing of intangible drilling expenses as a deduction and requiring instead that they be capitalized would be viewed by many in Congress as being a major move against the industries and against increased production. This action could seriously endanger the entire bill.

CEA Comment.--The phasedown of percentage depletion for independent oil and gas producers should continue after 1984 at 1 percentage point per year. This will complete the elimination of percentage depletion in 15 years. In addition, small oil producers are very wealthy and there is no reason why they should be taxed at lower rates than other citizens. Percentage depletion after 1985 is not necessary to provide incentives for oil and gas production. Under legislation proposed by the Administration, any new oil will receive the world price by 1985. Therefore there is no need for additional incentives. The effect of the depletion allowance is to "drain America first".

more rapidly?

Batter

Domestic Policy Staff.--The Policy Staff agrees with CEA that percentage depletion for oil and gas should be phased out after 1984, but it recommends that the phase out be completed in 5 years.

Interior Department Comment.--Interior believes that percentage depletion reform should not be included in the tax package. Interior believes that percentage depletion is an economic question affecting the United States mining industry and should be resolved by a study of that industry and not a study of the overall tax policy. According to that Department, the proper arena for resolution of questions relating to percentage depletion would be the interagency review of the nation's mineral policy, which is being led by Interior.

Treasury Comment.--Treasury agrees with the basic thrust of the CEA arguments. However, there is a current demand to provide incentives for oil and gas production. If any further phaseout in this area is to begin in 1985 there would seem to be adequate opportunity in legislation proposed in the future to deal with this problem.

Insofar as the interagency review of national mineral policy will not be completed for some time, it would appear to be bad timing to wait until that study is done for changes in underlying tax legislation.

Energy Department Comment.--The Energy Department agrees that a phase out of percentage depletion for oil and gas should not be proposed at this time.

Treasury Recommendations.--Percentage depletion for hard minerals should be phased out over a 10-year period. An alternative not recommended by Treasury: phase out hard mineral percentage depletion over 5 years.

Phase out over 10 years __________

Phase out over 5 years __________

Gas & oil also

Neither __________

Want to discuss further __________

Alternative not recommended by Treasury.--Percentage depletion for oil and gas should be phased out after 1984. This is recommended by CEA and the DPS.

Favor phase out over 15 years __________

Favor phase out over 5 years __________

Do not favor phase out at this time __________

Want to discuss further __________

Treasury Recommendations.--Intangible drilling expenses for oil and gas should again be placed in the minimum tax without regard to whether there is oil-related income. This would apply to both individuals and corporations.

Agree __________

Disagree __________

Want to discuss further __________

Alternative not favored by Treasury.--Eliminate expensing of intangible drilling expenses for oil and gas and require instead that they be capitalized.

Eliminate expensing __________

Do not eliminate expensing __________

Want to discuss further __________

(4) Financial Institutions

Present Law.--Credit unions presently are exempt from income taxes.

Mutual savings banks and savings and loan associations which invest a significant portion of their deposits in real estate loans are entitled to a special deduction (described as an addition to a reserve for bad debts) equal to 40 percent of their net income (this percentage will apply when the phase down is complete in 1979).

Commercial banks may also claim deductions for bad debts not consistent with actual losses as a result of favorable treatment originally granted by administrative action. At one time commercial banks were allowed a bad debt reserve equal to 2.4 percent of outstanding loans not insured by the Federal Government. The Tax Reform Act of 1969 phased this down to 1.2 percent of eligible loans for the years 1976 through 1981 and phased this down to 0.6 percent for the years 1982 through 1987. For later years, banks will base their bad debt reserves on their own experience in the current and 5 preceding years.

Proposal.--The special deduction for mutual savings banks and savings and loan associations would be phased down from 40 percent to 20 percent over a 5-year period.

The same deduction would be extended to credit unions, which would for the first time be made taxable.

Commercial banks would be required to base future additions to their reserves on their own actual experience in the current and 5 preceding years.

Revenue Estimate.--It is estimated that the change in the bad debt reserves for commercial banks will result in a revenue gain of $200 million. The estimated gain from mutual savings banks and savings and loan associations is approximately $170 million, and the revenue gain from the credit unions is about $100 million.

Discussion of the Issues.--The primary reasons for and against these proposals are:

Pro.--

- In the case of commercial banks, it would appear adequate to base their bad debt reserves on the individual experience of the banks in the current and last 5 years.

- Financial institutions should be required to pay taxes on actual income. The impact of the proposed changes on interest rates and competition among institutions will not be significant.

- The retention of half of the existing subsidy for mutual savings banks and savings and loan associations will continue to provide a subsidy for home mortgages. In addition, there are other subsidies to home ownership, such as the deduction for real property taxes and interest, which will continue to exist.

° Financial institutions receive special protection against losses in that they have a net operating loss carryback of 10 years as well as a net operating loss carryforward of 5 years. With this type of protection, the financial institutions do not need special bad debt reserves.

Con. --

° There will be opposition to taxing credit unions on the grounds that they are mutual organizations owned by their members, that the unions serve only the financial needs of those with a common bond of occupation and that much of the operation of the unions is performed by volunteer staffs.

° Commercial banks can take advantage of tax exempt municipal bonds, tax benefits through leasing operations and the foreign tax credit. It is claimed that in practice these advantages will not be available to credit unions.

° It is argued that the bad debt deduction for mutual savings banks and saving and loan associations is needed as a subsidy to be sure that funds are available for mortgage debt (as indicated above, an incentive is still kept for this purpose but at a lower level).

National Credit Union Administration Comment.--The Board opposes the removal of the exemption for credit unions. Their reasoning is set out in the first two "Cons" above.

HUD Comment.--HUD cites an analysis by a professor at Purdue University that is said to suggest that a reduction in thrift institutions' bad debt deduction to 20 percent would result in the withdrawal of funds from residential mortgages at the rate of about $3 billion per year largely into tax exempt bonds for each of the next 6 years. HUD states that such a massive redeployment of savings from residential mortgages to other media could have a serious impact on the production of housing.

Treasury Comment.--The above analysis assumed a 35 percent interest subsidy on taxable municipal bonds. If the subsidy rate is 40 percent (as it would be under Treasury proposals after 2 years), the yield on tax exempts will be driven down so that tax exempt securities will not be attractive to thrift institutions.

Treasury Recommendation.--The special bad debt deduction for commercial banks should be removed, the 40 percent bad debt deduction for mutual savings banks and savings and loan associations should over five years be phased down to 20 percent and credit unions should be subjected to tax to the same extent as mutual savings banks.

Agree ____________

Disagree ____________

Want to discuss further ____________

(5) Minimum Tax, Investment Credit Limitation and "At Risk" Limitation

Present Law.--Individuals whose tax preferences as defined by law exceed the greater of $10,000 or one-half of their regular tax liability pay a minimum tax of 15 percent on this excess. For corporations the minimum tax is based upon specified tax preferences to the extent they exceed $10,000 or 100 percent of their regular tax liability. The minimum tax rate in such a case also is 15 percent.

The investment credit can entirely offset the first $25,000 of tentative tax liability but generally only 50 percent of tax liability above that amount (for an interim period a more liberal rule is provided for railroads, airlines, and utilities).

The amount of any deductible loss in connection with one or more of four specified activities cannot exceed the amount by which the taxpayer is "at risk" in the activity. The at risk limitation applies to noncorporate activities for farming operations, exploring for oil and gas resources, holding or producing or distributing of motion picture films or video tapes and equipment leasing. A taxpayer is considered to be at risk to the extent of his cash and other property contributed to the activity and also to the extent of any borrowings with respect to which he has personal liability.

A separate provision applies in the case of partnerships. Here if a partner has no personal liability, the amount at risk for a partner is limited to his cash investment in the partnership. This, in effect, applies a general "at risk" limitation in the case of partners (including corporate partners) to all situations (other than the four specified above) except real estate investments. This rule does not, however, apply to individual investments.

Proposal.--The minimum tax would be retained in essentially its present form. Preferences which are directly eliminated, such as the capital gains preference, would, of course, no longer be subject to the minimum tax. Also, as previously indicated intangible drilling costs would be included as a preference for corporations as well as individuals and would not be reduced by oil and gas related income (this would reverse the decision for 1978 and subsequent years provided in the Energy Act).

In addition, complete elimination of tax liability by the use of the investment credit would be prevented by no longer allowing the investment credit to offset 100 percent of any taxes due. The investment credit could only offset 90 percent of tax liability. 7

The provisions which in certain circumstances limit tax deductions to the amount the taxpayer actually places "at risk" would be extended to cover all activities carried on individually or through partnerships or corporations (except real estate).

An alternative which Treasury will develop and which should be included as a possibility is taxing all limited partnerships with more than 15 partners as corporations.

Revenue Estimates.--It is estimated that the revenue effects of these proposals are: $115 million a year from the minimum tax change (most of this is from the change for intangible drilling expenses), $40 million a year from the investment credit change, and $20 million a year from the at risk change.

Discussion of the Issues.--The primary reasons for and against these proposals are:

Pro.--

- Where one or more deductions or credits can eliminate income there is a possibility that in the absence of a minimum tax individuals or businesses with substantial income will pay no tax. As long as this situation continues a minimum tax is essential if individuals or corporations with substantial adjusted gross income or profits are to pay some tax.

- Limiting the investment credit to 90 percent of tax liabilities appears desirable to prevent more persons from moving into a nontax status.

- It is believed that the cash flow from drilling activities is more than adequate to encourage investment even with the minimum tax applying.

- Congress has in effect determined that the "at risk" limitation should apply to all activities and can be applied to all taxpayers. It makes sense to do so in one strengthened form without the gaps and inconsistencies that arise when two rules apply to one problem. If "at risk" limitations apply only to specified activities or forms of doing business, tax shelters will be structured around them.

Con.--

- Taxing capital gains as ordinary income removes more than 80 percent of the base of the present minimum tax. With this much of the base gone it would be a step toward simplification to repeal the tax.

- Senators Long and Kennedy favor refundable investment tax credits and so will oppose any step to 90%. limit further the offset against tax of the investment credit. (Ullman, however, does not support the refundable credit.)

- The independents contend that drilling for oil is so risky that banks will not lend them money for this purpose and as a result they need their profits, without reduction by the minimum tax, in order to have sufficient funds for drilling.

Treasury Recommendations.--The present minimum tax should be continued but without capital gains as a preference and including intangible drilling expenses as a preference item for both individuals and corporations without regard to oil or gas related income.

Continue minimum tax __________

Do not continue minimum tax __________

Want to discuss further __________

A special limitation should be placed on the investment credit so that in no case could that exceed 90 percent of the first $25,000 of tax liability.

Why Ken/Long proposal?

Provide 90 percent limit ______

Do not provide 90 percent limit ______

Want to discuss further ______

The present provisions applying the "at risk" limitations should be extended to include activities whether or not the taxpayer is using the corporate form and whether or not he is operating through a syndicate. (As we develop this proposal it might prove advisable to tax certain limited partnerships as corporations in order to limit their use in tax shelters.)

Agree ______

Disagree ______

Want to discuss further ______